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ResPublica
changing the terms of debate

The Virtue of Enterprise:

Responsible Business for a New Economy

A ResPublica Essay Collection





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Essay Collection Edited by Caroline MacFarland

Caroline MacFarland was the managing director of ResPublica until March 2013 .

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About ResPublica

The ResPublica Trust (which operates under the trading name ResPublica) is an independent, nonpartisan think tank. We focus on developing practical solutions to enduring socio-economic and cultural problems in the UK.

Our ideas are founded on the principles of a post-liberal vision of the future which moves beyond the traditional political dichotomies of left and right, and which prioritise the need to recover the language and practice of the common good.

Based on the premise that human relationships should once more be positioned as the centre and meaning of an associative society, we aim to foster a 'one nation' approach to social and economic inequality so that the benefits of capital, trade and entrepreneurship are open to all. A vibrant democracy and market economy require a stronger focus on virtue, vocation and ethos. Consequently our practical recommendations for policy implementation seek to strengthen the links between individuals, institutions and communities that create both human and social capital, in order to achieve a political space that is neither dominated by the state nor the market alone.

New Economies, Innovative Markets

This workstream seeks to provide practical solutions for a moral capitalism and sustainable economy. This includes encouraging new market entry, ensuring supply chain resilience through more localised control, promoting greater diversity of business models and facilitating wider asset distribution, in order to achieve an economy based on trust and reciprocity.

ResPublica Essay Collections

ResPublica's work draws together some of the most exciting thinkers in the UK and internationally to explore the new policies and approaches that will create and deliver a new political settlement. Our network of contributors who advise on and inform our work include leaders from politics, business, civil society and academia. Through our publications, compendiums and website we encourage other thinkers, politicians and members of the public to join the debate and contribute to the development of forward-thinking and innovative ideas. We intend our essay collections to stimulate balanced debate around issues that are fundamental to our core principles.

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Foreword

Baroness Greengross OBE



The period since the global financial crisis has been very challenging for all companies as successive scandals have further eroded trust in business, notably in the financial industry, the media and the energy sector. At a time when household incomes are under intense pressure, and the Government is struggling to re-balance public finances, the suspicion that some major and highly profitable companies operating in the UK are avoiding paying their fair share of tax has also been toxic.

We know that neglecting values can have dire consequences for companies' reputation and sustainability. If business generally is to regain public trust and be held once again in high regard, it is essential that inspirational leaders ensure that decent values are embedded in the way their companies operate. It is also vital that business leaders publicly communicate these values in order to raise public awareness of them.

Professor John Kay has emphasised the need to create cultures that support a long term approach to investment, performance and pay and this has been repeatedly emphasised in meetings of the All-Party Parliamentary Corporate Responsibility Group. Our members also emphasise the significance of employee engagement which again is founded on strong corporate leadership and trust, as well as an authentic concern for employee well-being.

Responsible businesses are a vital force for good in our societies: creating jobs and providing the products and services that we all use in our daily lives. Without good corporate governance, however, businesses will only be tolerated and they will remain vulnerable to external shocks. Ethical business leadership will enable companies to demonstrate that they are acting in the long term interests of all their stakeholders and so regain public trust, building resilience and thereby ensuring their own long term success.

More information about the All-Party Parliamentary Corporate Responsibility Group and its activities is available at: www.apcrg.org.uk

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Introduction

Phillip Blond



The beginning of the 21st Century has marked a collapse of the old orthodoxies of markets and social order and it has prompted a wave of transformational social, economic, political and technological change which has already altered the way in which modern capitalism operates. It no longer seems clear that capitalism is operating in the general public interest and both left and right find great difficulty in shaping modern capitalism to the ends that the overwhelming majority of people want.

This collection of essays aims to move from public expressions of outrage and recrimination about corporate behaviour and modern capitalism into a more considered reflection on our expectations of personal and corporate behaviour, and our systems of governance and control.

Recent cases and ongoing controversies show that it is no longer acceptable to do what is legal, but make it imperative to do what is right. Yet opinion differs on how to enforce good behaviour. Is it enough to rely on individual and collective conscience, or can other methods be used to reinforce good behaviour and probity? Does the increased 'newsworthiness' of corporate practice indicate a new era of accountability and transparency, or is it increasingly challenging for regulators government and other responsible parties to hold companies to account?

It is vital that these questions are explored in the context of rapid technological change. This is why, in compiling this array of commentary from public leaders, commentators and academics, we have chosen to integrate thinking on the 'new economy' as particularly pertinent when thinking about the company of the future. The modern economy is an economy of information, of connecting people with each other, and what is most interesting about the Internet economy is that it is based on trust, on the reliance consumers place on the clicks and links that will connect them with information. And this trust is largely intangible, but inherently valuable. As such, new economy companies rely on reputation, social image and brand. And therefore their actions are more important than ever. It is not enough to deliver an effective product or service to consumers. The company of tomorrow must both project and demonstrate a public conscience and this public trust requirement might well be a new point for more effective regulatory and governmental intervention.

As Ian Powell outlines in Section 1, the challenges for modern business are evolving. Traditionally, business leaders' main responsibility was to create financial value for shareholders. However now the expectations of those stakeholders differ as to what constitutes 'value' and social legitimacy in the sense of not just what business achieves, but how it achieves it. Business does a great deal of social good but it is often perceived as utterly self-regarding: only 4% of Britons feel proud of British business.

Much of this decline in trust has been fuelled by recent newsworthy debates where public expectation sits at odds with business practice. John Mann MP, a vociferous critic of corporation tax avoidance, draws on the examples of Amazon, Google and Starbucks. Despite the high public profile of the debate, the focus on moral obligation and the spirit of the law underscores the legislative and regulatory impotence of policy leaders, who have a responsibility to lead change through both example and policy decisions. Stephanie Elsy, on the other hand, argues that Government can lead by selection as opposed to regulation and can create good cultures across its own supply chains. She calls for the role of the state as the commissioner of ethos and good practice, in the context of rising public procurement trends. Baroness Lister argues the case for a concept of stakeholder capitalism which views the employee as stakeholder and compensates them in recognition of this. Nathan Newman's analysis of data mining is a reflection of the growing public recognition that social network and search engine users give up their privacy without understanding the economic value of their data. Beyond business ethics and consumer choice, his arguments question whether the Internet is at the forefront of a new economy, or whether it serves to entrench current market failures.

Laws and regulation are designed to deal with market failures, and encourage businesses to operate to socially optimal outcomes. But, as all these examples demonstrate, outlawing bad behaviour has not stopped it taking place. Often the approach of regulators has been confrontational and has used the blunt instruments of high fines and strict enforcement rather than compliance and oversight. How then to best engender better behaviour in the public interest?

Section 2 explores these issues further. Does the increasing reference by commentators to 'responsible capitalism' indicate an emerging consensus around market competition, good governance and managing value? Or are there in fact inherent contradictions built into our understanding of modern markets? Roger Steare refutes the argument that more regulation means less wrongdoing. Instead, he promotes the ideal of better regulation that encourages culture based on trust between companies, customers, colleagues and communities. We need a better understanding of purpose, and how actions contribute to this purpose, in order to sustain value and culture. Andrea Leadsom MP, in reference to banking competition, also refers to interventions beyond regulation. She argues for an environment that allows free entry and exit of market players in order to 'compete away' the need for increased regulation on the basis of good practice.

Simon Caulkin highlights that the heroes of the 'new economy' are not lone entrepreneurs but players in an environment that is enabled or de-risked by the state. Increasingly, he argues, risk-bearers and reward-takers are different sets of people, meaning the benefits are disproportionately skewed in favour of self-interest rather than more widespread growth and prosperity. But, as Eric Jackson stresses, this self-interest is not sustainable, and cannot be, given the pace of change of the 'new economy' sector. Innovation does not imply infallibility, and a careful balance must be struck between competitive pressures so as not to limit innovation itself.

The essays in Section 3 point towards proactive ways in which to encourage accountability and compliance whilst fuelling growth, innovation and economic and technological progress. Good business practice recognises that organisations formed by, run by and answerable to people cannot function outside of a framework of morals and values, argues Chi Onwurah MP. Historically, limited financial liability was not supposed to recuse business from morality. Few would argue that the actions of business do not have social impact, but the real issue is whether they choose to recognise their civic and social responsibilities. Michael Izza too defines prosperous organisations as those which recognise long-term shareholder value and understand the business case for behaving with integrity. Formalising values, responsibilities and obligations – for example through a code of ethics – establishes a set of behaviours, reduces risk and provides a model that places the corporate sector at the service of a much wider community of stakeholders.

Lucy Marcus outlines the governance requirements that would see these changes. In the modern information age, corporate boards no longer operate behind closed doors: they are subject to increased public understanding and media scrutiny. The best boards do have the skill, vision and determination to improve business practice – and increasingly are expected to ensure their organisation has the longevity and fortitude to withstand the vagaries of the marketplace, serving not only those invested in the company today, but the stakeholders of tomorrow. A combination of 'grounding' – oversight of governance, compliance and risk – and 'stargazing' –



preparing for the unknowns of the future – is necessary to achieve this. Perhaps with these unknowns of the future in mind, Anthony Kleanthous focuses on changes in systemic concepts that are required to effect change in the way that the global economy operates. It is a sign of market failure that the current system does not internalise a truer understanding of value. Shann Turnbull proposes a model of network governance that would allow companies of the future to involve wider stakeholders as economic citizens so as to localise corporate accountability, increase self-governance and deliver genuine asset rewards in line with a human scale.

The views expressed in this collection are the views of each individual author. But it shows clear promise that there is such passion for change. All these authors would seem to converge on a need to move beyond approaching the regulation of markets as a technocratic, rules-based activity. Given the importance of trust to modern markets, new insurgent frameworks of governance and control are necessary to achieve a more just and long-term concept of stakeholder value and reward. It is up to policy makers to frame the rules of the game so that these companies be profitable but also good. And by fostering this climate for responsible and values-led business, we can cement the UK's place as a global business leader with genuine competitive advantage.

There is now a market demand for morality in business and ethics in economic outcomes. Very few Britons are proud of British businesses and this is an economic tragedy as well as a damning indictment of current business models. This essay collection sets out various institutional and cultural reforms that are needed to achieve the economy and society we all want. If business does not reform, the state will step in and will regulate and regulate again. Ignoring the moral demands of countries and people for better business practices will lead to businesses being driven from markets and shunned by customers. The market will select for morality - it is time business responded to the market.

Phillip Blond is an internationally recognised political thinker and economic commentator, who has offered strategic consultation and policy formation to governments, businesses and organisations across the world. He founded ResPublica in 2009.



Section One

*A Culture of Crisis?
Business Practice vs.
Public Expectation*

1



Tackling the Trust Deficit

Ian Powell, Chairman and Senior Partner, PwC

A trusted organisation is a more resilient organisation. Trust is key to harnessing and directing raw 'entrepreneurial spirit' to drive growth that's responsible, sustainable, and considers the interests of others. However, recent events have triggered a collapse in public trust in business, government and institutions of all types. For UK business as a whole to regain public trust, we need our political and business leaders to stand up and be counted, by reaffirming the positive role that business plays in society.

Trust is a very powerful asset. Without trust, business life becomes much more difficult – as demonstrated by recent events ranging from the global banking crisis, to the phone-hacking scandal, to the 'shareholder spring' of revolts against companies' remuneration policies. When trust evaporates, people and businesses stop communicating and collaborating, and seek to defend what they have rather than innovating to create something new.

Each of these natural responses to the absence of trust has a further impact: they restrict growth, both in specific businesses and in the economy as a whole. In the past few years, it has been the financial services industry, banking in particular, that has been most directly under the spotlight. But similar challenges have also emerged in other sectors ranging from energy to media, and from pharmaceuticals to social networks. The negative impacts on share price, cost of capital and liquidity can be measured and are both immediate and significant. The impact on morale, innovation and behaviour is more difficult to measure but perhaps even more damaging in the long term.

This is why trust is a critical asset for sustainable business growth and economic prosperity. However, unlike many other assets, trust cannot be bought or sold. Nor is building trust in today's world a public relations exercise. Instead, an organisation and its people can only earn the trust of society by consistently demonstrating the right behaviour: exhibiting values, and perhaps a vision of the future, that outside observers feel are aligned with their own. This alignment can only be sustained over time through true authenticity, both on the part of organisations and of the individuals within them.

New responsibilities for leadership

A key element of establishing trust is authenticity. And the need for authenticity has major implications for business leaders. Traditionally, their primary duty was to run their business well and so create financial value for shareholders. Things are no longer so simple. Today, leaders have growing accountability to an expanding array of stakeholders, each with their own varying definitions of what constitutes "value". For many of these interested parties, financial performance is now less important than behaving in a socially responsible way. An organisation's own employees fall into this category.

A further challenge for today's leaders is the pressure from the investor community for businesses to deliver short-term financial performance. This is a focus that tends to take precedence over all other aspects of the private sector, risking a situation whereby all other priorities become secondary to hitting the financial targets, and only if these targets are hit do the leaders get credit for everything else. Experience shows that the need to deliver short-term financial performance puts trust and authenticity under pressure.

More generally, the focus today in society is not just on what a business or public sector body achieves, but on how it achieves it. If it does things in a way that people like, then this builds a sense that it has social legitimacy, in turn generating trust and loyalty. This shift suggests that organisations with strong ethics are likely to succeed over those without. And in setting the right ethical tone, the values and behaviours exhibited by those at the top are key to how everyone in an organisation acts every day. As one business leader said; "I strive to communicate the right values every day — and sometimes I even use words."

Of course, it is crucial for leaders to communicate their values in a straightforward and consistent way, but as this comment illustrates they also have to behave in the right way. People watch behaviours, and what leaders say and do need to match up. Organisations whose tone and behaviours at all levels are aligned with the interests of those they affect and society as a whole can succeed in reinforcing trust with each individual interaction. Where this happens, I believe it is a strong sign that leadership is fulfilling its responsibility to be authentic, by revealing the organisation's true DNA and then letting other people decide for themselves whether it is worthy of their trust. A corporate strategy can only succeed through being aligned with thousands of interactions every day, not simply through a statement of strategic intent. And achieving this alignment demands clarity throughout the organisation about why it exists, together with a deep understanding of people's expectations and attitudes towards it.

Stability and sustainability in a volatile world

Even where trust is being earned, it is by nature fragile: it is axiomatic that trust takes years to earn and seconds to destroy. Today this is truer than ever. Trust is often built transaction by transaction, and is conditional on the individual's last contact experience. So a leader – and the organisation being led – may always be only one bad experience or error of judgement away from losing trust.

This fragility is compounded by the speed and transparency of communication today. The rise of social networking means word of one bad customer experience can spread like wildfire. And many people seeking information and forming opinions about a business will rely on distant acquaintances on Facebook or celebrities on Twitter more readily than on what's said by the press, governments, or companies themselves.

To manage the resulting threats to trust, leaders must ask questions of themselves and their businesses from the viewpoint of different interest groups, and take account of the answers in their behaviour and communications. What is the source of our social legitimacy? What values and cultural norms shape our decisions? What behaviours do our values and incentive plans really encourage? How are our desired values and behaviours connected throughout the organisation?

A further risk is that even the most deeply-embedded culture and values can be challenged at any time from within the organisation. When this happens, hard decisions need to be taken. To sustain the right culture, visibly tackling bad behaviour is as important as being seen to reward good behaviour. It may also be necessary to turn down potentially profitable business opportunities when pursuing them would run counter to the right values. In my view, every business should have a clear, straightforward and easily understood statement of its values. And the ability to challenge unacceptable behaviours is a key element of transparency and trust.

The vital role played by behaviour underlines that doing business responsibly ultimately depends on people rather than processes. Given the growing complexity of organisations and the pace of change in the surrounding environment, rules and policies will never be enough to ensure the right behaviour at every transaction and contact point. So rules must be underpinned by principles: a shared sense of purpose that's led from the top and resonates right the way through the organisation, a common culture that means people will instinctively do the right thing even when no-one's looking.



Closing the trust deficit through a national plan of action

In recent months, these shifts in the landscape of trust have been highlighted for me by a series of round-table discussions that we at PwC held with CEOs, chairmen, CFOs and senior non-executives in both the public and private sectors. The debates were wide-ranging, insightful, and full of practical ideas for tackling the “trust deficit”. One comment in particular has stuck with me. It came from a CEO who made the observation that a big part of the public’s lack of trust was ignorance about what business does, and about its true impact on society.

Business does many fantastic things. It creates jobs, growth and wealth. It pays the wages and creates the profits from which tax revenues are generated. It innovates to improve people’s standard of life. It builds infrastructure and communities. And it exports world-class products and services, bringing resources into the country in return. However, business is all too often depicted not as benefiting society, but as selfishly pursuing its own interests regardless of the costs to others. The impact of this steady drip-feed of negativity should not be underestimated: a recent Ipsos MORI poll showed that while many things make people collectively proud of being British, only 4% feel proud of British business.

This reflects a sentiment with profound consequences. It fuels an environment of cynicism and suspicion towards business that is at odds with the real values and behaviours of the vast majority of business leaders. And this cynicism in turn risks undermining global trust in the UK as a place to do business – one of the UK’s traditional strengths and a source of real competitive advantage on the world stage. Put simply, if we in this country don’t regard the UK as a trustworthy and conducive environment for business, then we have no grounds for complaint if the rest of the world takes the same view.

For the future wellbeing of the UK we must take urgent action to protect and build trust in British business, both at home and abroad. A concerted plan of action would have three major elements: a government that stands up for business – quite rightly holding business to account but also seizing every chance to reinforce the important role of business in wider society, leaders who set out a clear vision for the role of their business in society and rise to the challenge of converting rhetoric into reality, and robust dialogue with investors and other interested parties which includes reporting on the non-financial performance measures.

Responsible capitalism: A new licence to operate

Clearly a pressing objective for business leaders is a return to growth, and the opportunities and benefits that this will bring. But growth can only be sustainable if leaders in business and government pull together and shoulder their shared responsibility to regain trust. These efforts must extend to defining and embracing authentic values and behaviours.

In many ways, there has never been a more exciting time to be involved in business: witness the unprecedented opportunities brought by developments such as globalisation, remote working and instantaneous global communications. But these advances also bring new obligations. Responsible capitalism is no longer just a phrase to insert in the chairman’s introduction in the annual report; increasingly it makes up the core of a business’s licence to operate. Companies that ignore this sea-change may find themselves isolated in their industry, frozen out by their own customers, unable to recruit good talent, or even regulated out of existence.

By contrast, an organisation that rises to the challenge and earns trust through authentic behaviour will be more integrated into its communities, more resilient to shocks, and given more leeway by its investors, customers, regulators and other interested parties if and when a crisis hits. This will enable it to direct its raw “entrepreneurial spirit” to identify and seize growth opportunities, invest in innovation, and take risks, while staying true to its underlying principles throughout. This is why trust is key to responsible capitalism, and to its delivery of responsible, sustainable growth.

The extent of the trust challenge demands a long-term perspective, and not just words but concrete action. On a personal level, it requires a level of self-questioning and even self-doubt with which some business leaders may not feel comfortable. But in today’s era of social networking and rising ethical activism, trust underpins a business’s right not just to operate, but to exist. Leaders and their organisations ignore this new reality at their peril.

Taxing Times: Corporate Values and Consumer Value

John Mann MP

The level of tax paid by some of the multinational companies operating in the UK, and the schemes used to reduce the tax bills of wealthy individuals, have been the subject of much recent public debate, and exposed a distorted concept of fairness and accountability. The Costs of Tax Abuse, by the Tax Justice Network, based on data from 145 countries, shows that tax evasion costs those nations \$3.1 trillion annually.¹ In the UK's case £69.9 billion is lost on a yearly basis in what the Tax Justice Network call the "shadow economy." That figure, they point out, "represents 56% of the country's total healthcare spend."²

MPs questioned executives from Google, Starbucks and Amazon in November 2012, yet this debate focused on the morality aspect of paying less tax, since there is currently no regulatory or legislative barrier to corporations using techniques such as shifting profits abroad to lower tax nations through "transfer pricing", manipulating figures to produce a loss in the UK and directing turnover to offices in tax havens like Bermuda, Cayman Islands, Switzerland and Luxembourg.

At the moment such schemes are entirely legal, yet Britain seems more legislatively impotent in addressing such techniques than France and Germany. Notably, executives commenting on tax "efficiency" schemes seem to suggest a moral obligation to maximise shareholder value rather than a moral obligation to pay a fair level of tax. Whilst companies do exist to make a profit, the theory behind free market capitalism is that profits trickle down to the whole of society. This exposes a contradictory culture between corporations, reliant on consumers to buy their products, and the expectations of the tax payer, especially in an economic environment of welfare cuts, high unemployment and real wage stagnation.

What is interesting here is the corporate image that each firm projects, and the contrast with the issues raised by the tax avoidance allegations. None of these companies have acted unlawfully, but as many commentators have pointed out, the difference between the letter and the spirit of the law is an interpretation which often sits at odds with a company's brand image. These are all "young" companies which purport to embody lifestyle values, beyond consumer goods alone. Starbucks has, over the years, emphasised its commitment to corporate responsibility via Fairtrade suppliers and environmental standards. Google's mantra is do no evil – but does "evil" only refer to illegal behaviour, or is it a relative concept to those of fairness and accountability?

¹ The Tax Justice Network (2011) *The Cost of Tax Abuse: A briefing paper on the cost of tax avoidance worldwide* [Online]. Available at: http://www.tackletaxhavens.com/Cost_of_Tax_Abuse_TJN_Research_23rd_Nov_2011.pdf [Accessed 11 December 2013].

² Jenner, M. (2011) "Tax avoidance costs the UK economy £69.9billion a year", *New Statesman* 25 November 2011



Case studies: Starbucks, Amazon, Google and eBay

In November 2012, the Public Accounts Committee began an enquiry into tax avoidance, following public outcry that companies including Apple, eBay, Facebook, Google and Starbucks had avoided nearly £900 million of tax³. Appearing before MPs in the Committee, executives for Google, Amazon and Starbucks admitted to having used favourable European tax jurisdictions for their UK businesses.

Starbucks, which maintains 800 outlets in UK, has paid no corporation tax in the last three years. It reported that it was making a loss in the UK despite admitting in 2007 a 15% operating profit rate⁴. It has filed losses in the UK for most of the years it has been operating here, despite reportedly telling US investors that the business was healthy. Losses are achieved by charging themselves a royalty of 4.7% to the Netherlands regional office, where it has a “sweetheart deal” with the Dutch tax authorities, and by buying the coffee from the low-taxed Swiss office at a 20% markup on the wholesale price⁵. In the last thirteen years it has paid £8.6 million in UK tax and recorded sales of £3.1 billion⁶. By comparison, Costa Coffee recorded £377 million in sales last year, and its tax bill came to £15 million, or 31% of profits⁷.

Amazon paid £1.8 million in 2011 on a £200 million turnover according to Andrew Cecil, Amazon’s Director of Public Policy. Its profits are booked in low-tax countries and losses are filed in high-tax jurisdictions. Amazon Sarl, based in Luxembourg, for instance, gathers most of Amazon’s UK revenue even though it employs only several hundred people compared with 15,000 in the UK itself⁸. The company reports European sales through a Luxembourg-based unit which allows it to pay a rate of less than 12% on foreign profits in 2011, less than half the average corporate income tax rate in its major markets. Customers purchase goods through a UK website, are billed from the UK and goods are delivered from UK centres⁹. Amazon has reportedly received a demand from the French tax authorities for \$252 million for back taxes, interest and penalties related to “the allocation of income between foreign jurisdictions”¹⁰.

In the UK, Google has £2.5 billion sales and group wide profit margin 33%, yet tax paid is £3.4 million¹¹. A study conducted by accountants revealed that the Internet giant’s figures could have been more than £200 million in excess of this¹². The company operates a scheme under which its Irish subsidiary employs Google UK as an agent, meaning the proceeds of sales made in the UK end up in Ireland. A commission of around 10 per cent is then paid back to Google UK. That fee is taxable once costs have been deducted. Google Ireland then pays much of the money it makes to the Internet giant’s Bermudan firm as a licensing fee, ensuring that a large portion of its turnover ends up in the tax haven¹³. Overall it achieves tax on non-US profit at 3.2%.¹⁴ Again, in France, the tax administration authority is suing Google as part of a long legal scrutiny that began in 2012, when the company denied a newspaper report claiming it had received a back tax claim for 1 billion euros¹⁵.

3 Neville, S. and Malik, S. (2012) “Starbucks wakes up and smells the stench of tax avoidance controversy”, *The Guardian* 12 November 2012. BBC (12 November 2012), Starbucks, Google and Amazon grilled over tax avoidance, Available online at [<http://www.bbc.co.uk/news/business-20288077>].

4 Press Association (2012) “Starbucks executive denies lying about UK profits”, *The Guardian* 12 November 2012.

5 BBC “Starbucks, Google and Amazon grilled over tax avoidance”, 12 November 2012.

6 Syal, R. (2012) “Amazon, Google and Starbucks accused of diverting UK profits”, *The Guardian*

7 “Starbucks accused of tax avoidance”, *FoodService Footprint* 17 September 2012.

8 Syal, R. (2012) “Amazon, Google and Starbucks accused of diverting UK profits”, *The Guardian* 13 November.

9 Syal, R. (2012) “Amazon, Google and Starbucks accused of diverting UK profits”, *The Guardian* 13 November.

10 Reuters (2012) “Amazon ordered to pay \$252 million in back taxes by French authorities” *The Huffington Post* [Online]. Available at: http://www.huffingtonpost.com/2012/11/12/amazon-back-taxes_n_2117697.html [Accessed 11 December 2013].

11 Syal, R. (2012) “Amazon, Google and Starbucks accused of diverting UK profits”, *The Guardian* 13 November 2012.

12 Campbell, C. (2013) “Corporate tax avoidance 2013: following the Starbucks scandal, who has been paying their fair dues?” *This is MONEY.co.uk* [Online]. Available at: <http://www.thisismoney.co.uk/money/markets/article-2256860/Corporate-tax-avoidance-2013-following-Starbucks-scandal-paying-fair-dues.html> [Accessed 11 December 2013].

13 Rawlinson, K. (2012) “Google chiefs could face MPs over tax avoidance schemes”, *The Independent* 12 November 2012.

14 Syal, R. (2012) “Amazon, Google and Starbucks accused of diverting UK profits”, *The Guardian* 13 November 2012.

15 Bergin, T. (2012) “UK lawmakers slam Starbucks, Amazon and Google on tax” *Reuters* [Online]. Available at: <http://www.reuters.com/>

eBay avoided £50 million in tax by channelling profits through Switzerland and Luxembourg, it paid £1 million tax in UK in 2011-2012 despite £800 million sales. Fees paid by sellers using the auction site in Britain are handed over to a related company in Luxembourg called PayPal (Europe) Sarl, meaning that most sales are routed through a tax haven¹⁶. Using a group-wide profit margin of 23%, UK profits would have been £181 million in 2010. At the time this would have produced a corporation tax bill of £51 million. However, the amount of tax paid in total by eBay's four main UK-based subsidiaries for that year was £1.2 million¹⁷.

Business as usual? Accounting and accountability

The above are just four examples amongst many more. There is a stark contrast with the corporate image projected by these firms and the harsh reality. These are companies which like to portray themselves as purveyors of a higher ethical standard, but behind this façade are not prepared to pay for the social infrastructure that taxation provides. Nothing could be more obscene than Google benefiting from superfast broadband but not paying a fair share of tax: the taxpayer is effectively subsidising their profits.

During the public accounts select committee hearing, business representatives made a unilateral case in insisting their companies were acting within the letter of the law, and therefore doing no wrong. Matt Brittin, the UK boss of Google, was open about the processes that take place whilst Chairman Eric Schmidt voiced pride over the elaborate accounting structures. Brittin admitted that Google earns revenues when users of its UK search website click on advertising links. This advertising space is sold by a team of salespeople in the firm's Ireland office, whilst marketing consultants employed in the UK also refer clients to the Ireland sales team.

The enquiry also shed light on a number of accountancy firms and banks which promote and facilitate avoidance schemes, citing the interests of returns to shareholders as the driving principles behind these. On its own, public disapproval is not enough to change corporate behaviour.

In actual fact it was consumer pressure which did effect change. In December 2012 Starbucks announced it would pay extra tax, amounting to around £20 million, over the next two years. The select committee reported:

"...it is clear from Starbucks' reaction to our hearing on their tax practices that public opinion can influence the activities of many organisations. Despite this, HMRC does not publish the names of the firms promoting tax avoidance schemes, even where it considers the schemes contrive to avoid tax."¹⁸

However, although a petition demanded that Google pay its "fair share" of tax attracted nearly 40,000 signatures in just two days in August 2012¹⁹, Google has declined to revise its tax practices.

Morality and markets

The fundamental problem is one of morality. It would be far better if these companies were honest, admitting that their motives are driven by making as much profit as possible. Instead, in the absence of these terms of debate, this is a challenge for both corporate behaviour and standards set by regulators.

article/2012/11/12/us-britain-tax-idUSBRE8AB0B520121112 [Accessed 11 December 2013].

16 Duke, S. and Laurance, B. "eBay avoids £50m tax", *The Sunday Times* 11 November 2012

17 "eBay avoids paying £50m tax in the UK", *The Daily Telegraph* 21 October 2012

18 HMRC (2013) *Tackling marketed avoidance schemes – Public Accounts Committee* s 3 (19) [Online]. Available at: <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/788/78807.htm#n56> [Accessed 11 December 2013].

19 Rawlinson, K. (2012) "Petition launched as anger mounts over Google tax avoidance in the UK", *The Independent* [Online]. Available at: <http://www.independent.co.uk/news/uk/home-news/petition-launched-as-anger-mounts-over-google-tax-avoidance-in-the-uk-8031675.html> [Accessed 11 December 2013].



In the 2012-2013 Budget statement the Chancellor George Osborne emphasized targeting tax avoidance and evasion. Osborne claimed that through the reduction of loopholes and agreements with crown dependencies, these are expected to deliver £4.6 billion of new revenue. These measures also address wealthy individuals who use offshore tax havens.

However recent Government attempts are nowhere near strong enough, and the fact remains that it is difficult to clamp down legally on such schemes due to the difficulty of defining national profit and the need for other countries to simultaneously address their status as tax havens. Tightened loopholes risk disproportionately affecting small business which cannot afford the complex accountancy necessary to stay ahead of HMRC. Perhaps if there were greater transparency and HMRC and the Government built on recent efforts to identify the worst companies, consumers could influence these corporations by voting with their wallets. A ComRes survey conducted in February 2013 found that a third of consumers said that they were currently boycotting the products or services of a company because they felt it was not paying its fair share of tax in the UK²⁰. Yet the issue of tax avoidance has been a live campaign for years, spearheaded by organisations such as ActionAid. It was a multitude of circumstances which caused the public opinion groundswell in the first place. 72 of those surveyed in the ComRes study pointed to Government as having the responsibility to ensure that all UK-based companies pay the proper amount of tax in every country in which they operate. As well as national regulators, local government has a role to play here. Perhaps the planning system can help recognize that a family-owned café should not pay disproportionately more tax than the local Starbucks. Consumers could vote with their feet, but local authorities could level the playing field. Beyond individual business practice, this is a challenge for UK plc on the whole.

²⁰ ComRes (2013) "Poll Digest – Social – Christian Aid Tax Avoidance Poll" [Online]. Available at: <http://www.comres.co.uk/poll/863/christian-aid-tax-avoidance-poll.htm> [Accessed 11 December 2013].

Leading by Example: Challenges for the Public Sector Outsourcing Industry

Stephanie Elsy, Public Sector Consultant

Given recent issues with A4E, G4S and Serco, Government outsourcing companies must demonstrate exemplary corporate ethical behaviour if they are to win back and retain the trust of government and the wider public. Without this trust and confidence the outsourcing sector will always be dogged with controversy.

There have been countless examples of public sector outsourcing companies coming under the spotlight of late. Nick Buckles, former Chief Executive of G4S, was grilled by the Home Affairs Select Committee over their Olympics security contract and left the company a few months later; Emma Harrison, former Chairwoman of A4E, eventually resigned too after her ill-judged decision to award herself £8 million in pay after clear and substantial Work Programme contract failings. Most recently, Serco have been before the PAC and are due to appear again soon following allegations of fraudulent record keeping and invoicing in their Cornwall Out of Hours contract and their MoJ Tagging and Court Escort Services. They now face the extraordinary possibility of being blacklisted by HMG and are rapidly reviewing their corporate governance and leadership. These PR and commercial disasters have dealt a major reputational blow to the government outsourcing industry in the UK. But in each case they could have been avoided if the leaders of the companies concerned had really understood that government outsourcing companies don't just have to be good companies. They have to be the best, most ethical companies.

The one million plus people working in this industry, which is otherwise a major UK success story, have been completely dismayed but not entirely surprised by these events. When senior corporate executives delivering services on behalf of the taxpayer think they can get away with underperforming contracts while making large profits and paying themselves telephone number remuneration packages, they must expect to be put under the spotlight in this way.

Until recently, most opinion surveys have shown the public to be agnostic about the private sector delivering important public services. They don't for the most part care who provides a service, so long as it is a good one and represents value for money. Problems arise when the public feel their money is given to companies and investors which do not deliver quality and value, and to executives who line their own pockets at the taxpayers' expense.

The rise of outsourcing and the changing role of the State

Front line service delivery by the private and charitable sectors is nothing new. Prior to the introduction of the NHS and post-War welfare state, all public services and goods were delivered in this way. Since the 1980s there has been significant increase in outsourcing, within the context of austerity and diminished government capital. This trend is more than likely to continue in spite of these scandals given future procurement trends in the NHS, prison services and the move towards public sector spin outs, all of which have brought the sector under renewed scrutiny.



There are many benefits to private sector-led service delivery. Studies have consistently shown that competition can generate savings in the order of 20% with no loss of quality, whether or not the service is outsourced. The private sector has the added advantage in these straitened times of being able to introduce investment capital to cover the costs of change and the modernisation of technology. Outsourcing can also help the Government focus more on its core functions – representing the interests of the taxpayer and developing key policies and strategies – rather than service delivery. It should be the case that whoever is best placed to run the contract should win the bid, whether public, private or voluntary sector.

For the most part, the outsourcing industry has delivered considerable value and quality to the public purse. Unfortunately for the reputation of the industry, companies do not get plaudits for delivering what they have contracted to do – even when they do it exceptionally well. It is self-evident, though, that any organisation run by human beings is capable of making mistakes and getting things wrong. We should not be surprised that it happens from time to time. Sometimes these failures provoke an outrage that is disproportionate to the harm done. Arguably, the real test for outsourcing companies should not be “do they ever get things wrong”, but how they respond when they do: whether they are accountable, responsible for mistakes and responsive to customers. These are the behaviours of a company with good corporate values and behaviours that can be trusted. Like any company, if government contractors do not behave in this way and attempt to shirk their responsibilities, then they certainly deserve the derision they get. Commissioners are entitled to punish them by invoking penalty clauses and, if appropriate, barring them from future work until they are satisfied they have changed their culture and behaviour.

Good companies are good employers

A major test of the true ethical character of any business is how they treat their workforce. Fear that pay and conditions will be cut in order to pass on savings to the government customer, or worse, to add to the profits of the company, is a legitimate concern of current and prospective employees of government contracting firms. This is not without foundation. Whilst Transfer of Undertakings (TUPE) regulations apply when work is outsourced, their protections are limited and unethical employers can usually find a way, over time, to cut pay and conditions if they are minded to do so. Such contractors have given a bad name to the industry and generated fear in the workplace which creates huge political barriers to reform. In the absence of these issues within procurement requirements, even the more ethical contractors will be susceptible to the competitive pressure to push pay down to the lowest level the market will bear.

This race to the bottom means that many outsourced low-skilled jobs are now paid at the minimum wage, and zero hours contracts have become commonplace. Meanwhile senior executive pay in many outsourcing companies has increased, often at a disproportionate pace. Notwithstanding debates about fairness and justice – which Baroness Lister covers elsewhere in this collection – in the case of outsourcing companies, this results in the taxpayer supporting low-paid families through the benefits system instead.

Good companies treat their current and TUPE'd employees with respect and care and in many cases productivity improvements can improve conditions for the workforce – the rail industry is a good example of this. However, good practice happens in spite of the procurement process, not because of it. The market and the discretion of the contractor prevail.

If government wants employers in the public sector to act as responsible employers, paying a fair wage, taking on apprentices and training their staff, it needs to start at home. This does not have to be a debate about regulation versus free market; it is about meeting certain requirements to tender government contracts. The Mayor of London and many local authorities have committed voluntarily to pay the living wage. If all government contractors required their contractors to pay a living wage as part of their procurements it would reassure outsourced workers, improve retention in the workforce and create a level playing field for all contractors.

Furthermore, at a time when government (and business) are looking at senior pay, the gender and racial composition of Boards and management teams, public scrutiny of companies that do a large part of their business with government is not only inevitable but wholly appropriate. If a large part of the profits of companies come

from the taxpayer, then not only should government look at the pay of the most senior executives, as they do at pay in government, but they should look at the corporate governance of those businesses as well. If one part of government is trying to encourage diversity and constrain pay excesses in business and government, it would be inconsistent to ignore these matters in its own supply chain.

Good behaviours are relative to the system in which they operate

Connected to the above issue is the way that prime contractors manage their own supply chains. There have been many complaints from the sub-contractor charities, particularly in the current Department for Work and Pensions' (DWP) Work Programme, that private companies have used charity brands in bids as "bid candy" and that these have then not received any work – as was the case with Eco-Actif, which subsequently went bankrupt. Such conduct should not be tolerated either by those charities or the commissioners that have awarded contracts in part due to those supply chains. Gagging clauses should not be used to silence these organisations.

Commissioners should care about how services are delivered, monitor their contractors and intervene where there is underperformance and poor practice. They should also require larger contractors to responsibly manage their own supply chains and in doing so help to develop a more vibrant marketplace. In addition, if it is government policy that all FTSE100 companies are encouraged to follow the Prompt Payment Code, then it is a small step to include that requirement in all government contracts and frameworks.

It would be expecting too much to ask companies not to maximise their profits, but government can make sure they are fair and appropriate through open book accounting and gain sharing mechanisms. These practices are commonplace in contracting and can make sure the taxpayer is protected from profiteering. Some public bodies have gone further and created joint ventures with the private sector so they too can benefit from both savings and profits earned. So there are ways of ensuring that profit levels are fair to the taxpayer.

Of course, outsourcing of public services has been politically controversial for some, particularly on the Left. They argue that public services cannot be trusted to a private sector motivated by profit. This concern is very much affected by custom, culture and practice and is not necessarily rational. If it is acceptable for hospitals to be built and equipped by construction companies, equipment manufacturers and agencies supplying nurses who all make a profit, why is it unacceptable for other services like cleaning and catering and out of hours GPs to be provided by the private sector?

The real issue should not be that companies do such tasks and receive a margin from taxpayers' money, but whether the market is operating competitively and that margin is reasonable. It would be wrong to suggest that outsourcing companies are any better or worse in their behaviour than other businesses – they are not. But not only should government suppliers be good corporate citizens, they need to be leading the way ethical business practices.

Many people working in these companies came from the public sector and have retained the public service values. They go to work to do a good job and those working for government either directly or indirectly have the added sense of pride of working for their country or community. However, people only behave as well as the system they operate in allows and incentivises them to do. Given the right environment and framework to operate within, they would be able to do an even better job. And firms themselves, their Boards and their investors need to understand that it is in their interests that that should be the case.

Towards a Responsible Pay Structure

*Baroness Ruth Lister, Member of the House of Lords and
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Public anger at irresponsible capitalism is based on the perception of inequities between pay at the top and bottom. Whilst the elite have seen increasing rewards, the majority have seen stagnation in wages and a decline in living standards. This symptom of irresponsible capitalism was scrutinised by the High Pay Commission, the 2011 independent inquiry into high pay. In an interim report, it observed: "Those who head our biggest companies have a responsibility to their workers and to the society they sit within. We should be demanding ethical leadership from our captains of industry regarding pay at the top."¹ In thinking about responsibility, however, it is worth reflecting more generally on the Commission's appeal to companies so as to discuss how responsible capitalism might address the burning question of inequality at both ends of the pay hierarchy.

The High Pay Commission frames the issue of pay inequality as one of responsibility. Responsibility has for the last few decades dominated political rhetoric², however, the searchlight of responsibility is always beamed on "the poor". It is rarely the rich, despite the disastrous economic impact of the irresponsible behaviour of those in the City and the boardroom, who bear the brunt of this. The rhetoric of responsibility when applied to those at the bottom is often accompanied by denunciations of a supposed widespread "culture of welfare dependency". Rather less is said about the culture of dependency among irresponsible employers who pay low wages subsidised by the taxpayer through tax credits.

The size of the tax credits bill in the context of austerity economics has been one factor in the growing interest on the left in "pre-distribution", the rather clunky term used to talk about the original distribution of income and wealth as opposed to the post-tax and benefits distribution. Inequality in wages, particularly at the top, has been a key driver of the accelerating income gap in recent years (even though 2010-12 saw a – probably temporary – narrowing of the overall income gap). Responsible companies thus have a potentially critical role to play in reducing inequality.

The review of high pay in the public sector, carried out for the Prime Minister by Will Hutton, argued for "fair pay as a social norm" and recommended a fair pay code.³ The idea of 'fair pay' probably resonates rather more than that of "pre-distribution". While Hutton's review was specifically focused on the public sector, its findings have wider relevance. Hutton himself suggested that since "fairness is crucial in hard economic times... Government has an opportunity to use the public sector to set an example on fair pay to the economy as a whole".⁴ Although principles of fair pay apply to the full range of the wages distribution, particularly with regard to the gender pay gap, the focus here is on the top and bottom.

1 High Pay Commission (2011) *More for Less: What has happened to pay at the top and does it matter?* London: High Pay Commission, p. 18.

2 Lister, R. (2011) "The age of responsibility: Social policy and citizenship in the early 21st century", *Social Policy Review*, 23. pp. 63-84.

3 HM Treasury (2011) *Hutton Review of Fair Pay in the public sector: Final Report*.

4 HM Treasury (2011) *Hutton Review of Fair Pay in the public sector: Final Report*, p.13.

Debating inequality: fairness and desert

The notion of fairness, as both Hutton and the High Pay Commission acknowledge, is “elastic” and “elusive”. Nevertheless, research suggests two broad orientations towards what constitutes fair pay. The first and more dominant is an individualistic orientation encapsulated in the notion of “desert”. The second is a more egalitarian orientation, which judges fairness in relative terms. The concept of desert has emerged within numerous empirical studies⁵ as a critical criterion for assessing whether high pay is justified, and *how* the weight of the role and the responsibilities attached to it, together with the knowledge and skills required, should be recognised and rewarded.⁶ Yet there is also a view expressed that the risks and responsibilities associated with lower paid jobs, particularly involving caring, are often underestimated⁷ while, according to the High Pay Commission, the level of risk associated with senior roles is often overestimated.⁸

Hutton relates reward for executive performance to “the achievement of organisations’ long-term objectives and core function”⁹; what politicians tend to describe as “rewards for success”. Whilst participants in an IPPR study considered “how hard someone works and how well they do their job” as important factors in the level of reward, some also pointed out that it is easier to measure and recognise performance in some jobs than others and were sceptical as to how far good performance is in fact reflected in pay at all levels.¹⁰ Their scepticism receives confirmation in a High Pay Commission discussion paper, which notes how since the mid-1990s, the link between executive pay and performance has led “to huge increases in performance-related remuneration” without a “corresponding leap forward in company performance”.¹¹

As for performance “at all levels”, there appears to be an implicit, and sometimes explicit, assumption in much public debate that high earners deserve their rewards in part because of their effort and their contribution to success. Yet it is not axiomatic that their level of effort is so much greater than that of many people earning lower wages. Some people’s effort (and also skills and abilities) are valued more than others’, reflecting factors such as status, prestige and gender as much as effort and ability as such. This skewed perception of differential effort and ability is reflected in the common use of phrases such as “the wealth creators” to describe a small number at the top of private sector organisations, with the implication that wealth is not also created by the hard work and ability of the mass of employees. Such assumptions were challenged by many low to middle earners as well as public sector high earners in the IPPR study. A key finding was “a sense that the contribution of high earners is often overplayed while the contribution of the average worker is undervalued”. This failure “to recognise the contribution that most employees make to organisational success was... seen as a source of unfairness”.¹²

This suggests that even if one approaches the question of what constitutes fair pay from the individualistic orientation of desert, it cannot be divorced from a more relative orientation. Indeed, a report of a JRF study observes that: “it was noticeable that the concept of desert employed by many participants to discuss earnings from work was a comparative one, incorporating an assessment of the relative levels of reward for different individuals”.¹³ Emphasising the importance of collective endeavour in the creation of value and an organisation’s success, Hutton argues that the fruits of that success should not therefore accrue “disproportionately to particular individuals. Proportionality thus implies some limit on pay dispersion between high and low earners”.¹⁴

5 Bamfield, L. and Horton, T. (2009) *Understanding attitudes to tackling economic inequality* York: Joseph Rowntree Foundation; Lanning, T. and Lawton, K. (2011) *Getting what we deserve?* London: Institute of Public Policy Research.

6 HM Treasury (2011) *Hutton Review of fair pay in the public sector: Final report*; and Lanning, T. and Lawton, K. (2011) *Getting what we deserve?* London: Institute of Public Policy Research.

7 Lanning, T. and Lawton, K. (2011) *Getting what we deserve?* London: Institute of Public Policy Research.

8 High Pay Commission (2011) *More for Less: What has happened to pay at the top and does it matter?* London: High Pay Commission, p. 59.

9 HM Treasury (2011) *Hutton Review of fair pay in the public sector: Final report*, p. 87.

10 Lanning, T. and Lawton, K. (2011) *Getting what we deserve?* London: Institute of Public Policy Research.

11 Tatton, S., Elston, A. and Matthews, J. (2011) *What are we paying for? Exploring executive pay and performance*, London: High Pay Commission, pp.6 & 8.

12 Lanning, T. and Lawton, K. (2011) *Getting what we deserve?* London: Institute of Public Policy Research, pp. 32 & 28.

13 Bamfield, L. and Horton, T. (2009) *Understanding attitudes to tackling economic inequality*. York: Joseph Rowntree Foundation, p. 43.

14 HM Treasury. (2011) *Hutton Review of Fair Pay in the public sector: Final Report*, p. 20.



From low to fair and decent pay

Both the JRF and IPPR studies found a concern about low pay and a belief that the minimum wage is too low. This was seen as unfair on grounds of lack of recognition of the effort involved or the contribution made or of failure to meet needs – reflected in the growing political support for a ‘living wage’. According to the Resolution Foundation’s Commission on Living Standards, given that 20 per cent of the UK workforce are paid less than the living wage, the minimum wage, successful as it has been, does not of itself constitute a policy for tackling low pay. In the context of the decline in private sector collective bargaining coverage, it recommends that the Low Pay Commission’s remit should be widened to cover an assessment of which sectors could sustain a non-mandatory “‘affordable wage’ higher than the national minimum”.¹⁵ This, it suggests, could be enhanced by “a more experimental approach” that would for instance encourage new pay norms. To this end, the Commission on Living Standards supports greater pay transparency and recommends that the Corporate Governance Code is amended to require large companies to report the proportion of their workforce paid below a low pay threshold such as the living wage or the OECD’s threshold of two-thirds of the national gross median hourly wage.

Despite the impressive success of the living wage campaign, the idea of a living wage is problematic because it “confounds hourly gross wages for an individual with weekly disposable income for a household”.¹⁶ Wages cannot take account of family size – indeed that was one reason for the introduction of family allowances – and therefore the idea that a living wage can accommodate the diverse family circumstances of workers is misleading. In contrast, a threshold linked to the median wage links the rewards for a worker’s contribution not to basic needs but to the rewards for others’ contributions. The notion of a ‘decent wage’ better captures the idea that every worker deserves a decent reward for their efforts. It also chimes with the broader vision of “decent work” promoted by, among others, the International Labour Organisation and the UN Economic and Social Council. Decent work is about working conditions and security as well as pay and is premised on recognition of human dignity.

There is no need for the responsible business to wait for a lead from government or the Low Pay Commission to assess whether it can afford to pay its low paid workers a decent wage. It could take on board and adapt Hutton’s Fair Pay Code, including its proposed “fair pay process”. As part of such a process, Hutton suggests that “to reflect the social nature of the organisation and the fact that organisations’ success is the product of collective efforts by the workforce as a whole, the process for determining senior pay must take account of the relationship between senior pay and that of all employees, and must give a voice to the wider workforce”.¹⁷

Imagine a Rawlsian “veil of ignorance” exercise whereby all employees are asked for their views about the appropriate range of rewards. Of course, this would be only partial ignorance because participants would know roughly where they were placed in the company hierarchy but they would not know what other workers are paid. Indeed, despite public concern about wages inequality people tend to underestimate significantly just how high pay is at the top. A Rawlsian veil of ignorance exercise followed by an actual pay audit (which also incorporated the gender dimension) would thus probably make for uncomfortable reading. But, provided that the results weren’t ignored, such an exercise could enhance employee motivation and engagement, which are “significant determining factors in business success”.¹⁸

15 Commission on Living Standards (2012) *Gaining from Growth*, London: Resolution Foundation, p. 140.

16 Bennett, F. (2012) “Reflections on the ‘living wage’”, *Soundings*, 52. p. 66.

17 HM Treasury (2011) *Hutton Review of Fair Pay in the public sector: Final Report*, p. 85.

18 High Pay Commission (2011) *Cheques with Balances: why tackling high pay is in the national interest*. London: High Pay Commission, p. 27.

Information Asymmetry: The New Inequality?

Nathan Newman, NYU Information Law Institute Fellow

Networked and social systems of communication are upending how we understand, and should understand, markets and regulatory systems. The relationship between new technology products, their users, and their clients such as advertisers illuminates a fundamental disconnect between corporate behaviour and consumer expectation.

The “new economy” has heralded an age of bespoke consumerism. Online profiling now means that our preferences and habits, relating to music, food, entertainment, literature and consumption of news, can now be tailored to not only the existing interests of the user, but their projected behaviours. Increasingly, social networking products are data mining tools to extract precise personal information. Data mining and advertising in conjunction with online profiles have sparked a multi-million pound global industry, but have also led to deeper concerns regarding privacy, market competition and the potential resulting consumer harm – all alongside a much more general public concern with companies perceived to be predatory and unaccountable. This is not just a question of technological mediation of information. It is about the entrenchment of economic and social inequality. The key issue explored in this essay is: Is information asymmetry a root cause of rising economic inequality? Joseph Stiglitz, former World Bank Chief Economist and Economics Nobel Prize Winner, has for decades studied how information asymmetry in particular markets undermines the easy assumptions of many economists that competition will correct problems of monopoly. Information is itself a commodity and particular companies can in Stiglitz’s words “appropriate the returns to creating information for economic advantage in the market place.”¹ Stiglitz and allied economic thinkers argue this increasing information asymmetry feeds increasing economic inequality as well, such that the “result from the new information economics is that issues of efficiency and equity cannot easily be delinked.”²

The last four decades have seen a steady increase in economic inequality, which is only partially explained by standard explanations centred on the rise of economic returns to education, globalized trade and political changes. The increasing information asymmetry in consumer markets, driven by data mining and facilitated by online services, may be an additional significant cause of this overall increase in economic inequality.

Price discrimination and the wider landscape of information

The positive potential with targeted communication and online adverts is that companies can find the customers interested in their products—and that’s part of the story. But it’s not just finding customers; it’s finding out what price different groups of customers will pay for the same product or service and marketing it separately to them at those different prices.

1 Stiglitz, J. E. (2002) “Information and the change in the paradigm in economics”, *The American Economic Review* 92. pp. 460, 463

2 Stiglitz, J. E. (2002) “Information and the change in the paradigm in economics”, *The American Economic Review* 92. p. 479



This facilitates what economists call “price discrimination,” selling the same exact good or service at a variety of prices in ways unknown to the buyers. This is based on the reality that people have different maximum prices that they are willing to pay, a so-called “pain point” after which they won’t buy the product.³

The ideal for a seller would be to sell a product to each customer at their individual “pain point” price without them knowing that any other deal is available. In general, economists believe that where consumers do know all the pricing options, they can benefit from price discrimination. The classic example is airline pricing, where consumers willing to book ahead and take only certain flights get a lower price, while more well-off or time-sensitive consumers will pay more for the same seat to book at the last minute for a specific flight. This arguably fills seats, increases revenues for the airline and gives some people access to cheaper seats that might not be available at all at the lower price without price discrimination.

The problem arises when consumers don’t have all needed information.⁴ With public advertising, a customer willing to pay a higher price will generally demand the lower price advertised to someone else, although they may not notice the alternative ad, creating some imperfections in the marketplace. However, data mining and targeted Internet advertising allows sellers to make different advertising offers to particular groups of consumers based on correlations derived from past behaviour that are essentially invisible to anyone charged a higher price or missing out on a coupon.⁵ Offering full-price offers to some online buyers while selectively offering discounts to others based on online profiling is one of the most pervasive forms of price discrimination operating in online sales.⁶

The technology industry too has had its fair share of scandal. Competition and privacy authorities around the world are now closely examining the practices of Google—and in doing so, they will be opening up a window into the far larger and disturbing world of online data mining and the ways inequality in access to information in the market is in turn driving broader economic inequality in the economy. These are increasingly key parts of online firms’ business models – Hal Varian, the Internet giant’s Chief Economist, is an expert in the topic who has written extensively about price discrimination in online advertising. In 2005, his year of appointment, Varian outlined the advantages to advertisers of online marketing and price discrimination in an in-depth economic analysis of the practice in a piece he co-authored for the journal *Marketing Science*. He highlighted the failure of most price discrimination to yield profits in traditional marketing because of its visibility to most customers, but that “significant initial investments in information technology can lead to competitive advantages” that lock in user loyalty while collecting personal information to make price discrimination profitable.⁷

Varian noted that differential pricing will be most effective on “the fraction of the potential population [which] is myopic and ignores the impact of their current behaviour on future offerings,” advocating corporate practices that undermine the ability of users to make their behaviour anonymous to reduce user ability to evade price discrimination.⁸

3 Ayres, I. (2007) *Super Crunchers: How anything can be predicted*, London: John Murray, p. 173 (“[Firms] are becoming more adept at figuring out how much pricing pain individual consumers are willing to endure and still come back for more.”) Analyses ways firms use data mining to set individualized coupon discounts even at traditional stores.

4 See Joseph E. Stiglitz (2002) ‘Information and the Change in the Paradigm in Economics’, *The American Economic Review* 92; see also Salop, S. and Stiglitz, J. E. (1977) ‘Bargains and Ripoffs: A Model of Monopolistically Competitive Price Dispersions’, *Review of Economic Studies*, 44(3), pp. 493-510; Lippman, S. A. and Levine, D. K. eds. (1995), *The Economics of Information* Cheltenham: Edward Elgar; Salop, S. (1977) ‘The Noisy Monopolist: Information, Price Dispersion and Price Discrimination’, *Review of Economic Studies*, October 1977, 44(3), pp. 393-406. Stiglitz, J. E. (1977) ‘Monopoly, Non-linear Pricing and Imperfect Information: The Insurance Market’, *Review of Economic Studies*, October 1977, 44(3), pp. 407-30.

5 Clifford, C. (2010) ‘Web Coupons Know Lots About You, and They Tell’, *New York Times* [Online]. Available at: <http://www.nytimes.com/2010/04/17/business/media/17coupon.html> [Accessed 11 December 2013]; Ayers, I. (2007) *Super Crunchers: How anything can be predicted*, London: John Murray, p.175.

6 Singer, N. (2012) ‘You for Sale: Mapping, and Sharing, the Consumer Genome’, *New York Times* [Online]. Available at: <http://nyti.ms/LcBw0g> [Accessed 11 December 2013]. (Detailing online targeting by Axiom, the article details how a company “assigns consumers to one of 70 detailed socioeconomic clusters and markets to them accordingly [...] Analysts say companies design these sophisticated ecosystems to prompt consumers to volunteer enough personal data — like their names, e-mail addresses and mobile numbers — so that marketers can offer them customized appeals anytime, anywhere.”)

7 Acquisti, A. and Varian, H. R. (2005) ‘Conditioning Prices on Purchase History’, *Marketing Science*, 24(3), p. 367.

8 Acquisti and Varian (2005), p. 368.

Users of Google Search and Gmail are not actually the customers; they are the product sold to the company's advertising clients.⁹ These forms of new technology allows advertisers access not to a particular media product but to each individual user based on their particular interests, demographic characteristics, location and the range of other information collected from users. In fact, products like Gmail or social networking sites such as Facebook are more than content systems in which to deliver advertising; they are tools to extract ever more precise information about those users to allow advertisers to more effectively target particular ads to those users.¹⁰

This has implications for market competition. In the antitrust context, the unrivalled and entrenched knowledge of consumer personal information by Google makes the ability of any rival or potential rival to woo online advertisers away from Google often nearly impossible and creates an anticompetitive barrier to entry.

The cost of lost privacy: Market exchange or consumer harm?

Defenders of the techniques employed argue that users benefit from a rational market exchange. In exchange for providing some personal data to Google, those users get access to a valuable service. But this is based on the assumption that the market is functioning in such a case, which requires that users properly price their personal information and the opportunity cost of giving it up, and that there are no economic byproducts of Google's monopoly control of user data that reduce consumer welfare more generally. In fact, users generally don't understand the value of their data¹¹ and give up their privacy without getting even close to the economic price for which it is de facto resold by Google and other online companies which act as "banks" of these data – and profit accordingly. Data mining and consumer research allow marketing to each individual based on a multivariable profile created through search patterns and demographic profiles. Since 2009, Google has been rolling out beta tests of such behavioural profiling for advertisers and last year fully implemented its coordination of advertising with targeting demographic groups identified by Google based on user browsing activity, behaviour, and physical location.¹²

Scholars Rosa-Branc Esteves and Joana Resende have highlighted the ways, because of the low costs of online advertising,¹³ such online price discrimination can reduce consumer surplus to the advantage of corporate profits.¹⁴

9 This reality is sometimes obscured in discussion of Google being involved in "two-sided" markets or being an "intermediary." See Manne, G. (2011) "Some Much-Needed Antitrust Skepticism on Senate Letter Urging FTC Google Investigation," *Truth on the Market* [Online]. Available at: <http://bit.ly/Ou3TcJ> [Accessed 11 December 2013]. (Refers to "two-sided markets like Google's (where, in a sense, one platform produces two inter-related products (searches and ancillary Google stuff for users and advertising space for advertisers))"). However, users make searches or access YouTube not to gain access to products Google generally contracts to license or produce, but instead gain access to products that are themselves produced freely by others. The barter nature of the exchange of personal privacy with Google also highlights the lack of a functioning market on the user side.

10 From the perspective of control of private data, Google's real competitive rivals are data services like Axiom, although such companies lack Google's access to users at the point of search decisions. See Singer, N. (2012) "You for Sale: Mapping, and Sharing, the Consumer Genome," *New York Times*, June 16 2012 [Online]. Available at: <http://nyti.ms/LcBw0g>.

11 See Whittington, J. and Hoofnagle C. J. (2011) *Unpacking Privacy's Price*, 90 N.C.L. Rev. 1327. ("American consumers profoundly misunderstand the rules underlying these transactions; they do not understand the terms of trade p.1357; Kumaraguru, P. and Cranor, L. F. (2005) "Privacy Index: A Survey Of Westin's Studies", Institute For Software Research [Online]. Available at <http://reports-archive.adm.cs.cmu.edu/anon/isri/2005/CMU-ISRI-05-138.pdf>. [Accessed 11 December 2013]. (about half of Americans believe that "[m]ost businesses handle the personal information they collect about consumers in a proper and confidential way."); Hoofnagle, C. J. and King, J. (2006) *Research Report: What Californians Understand About Privacy Offline* [Online]. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133075 [Accessed 11 December 2013]; Acquisti, A. and Grossklags, J. (2008) "What Can Behavioral Economics Teach Us About Privacy?", in Acquisti, A. et al., (eds) (2008) *Digital Privacy: Theory, Technologies and Practices*, New York: Auerbach Publications, p.363 (bounded rationality, optimism bias, and information asymmetry lead consumers to undervalue personal information).

12 Parker, P. (2011), "Google Rolls Out Behavioral Targeting To All AdWords Advertisers", *Search Engine Land* [Online]. Available at: <http://searchengineland.com/google-rolls-out-behavioral-targeting-to-all-adwords-advertisers-82976> [Accessed 11 December 2013].

13 See Esteves, R. and Resende, J. (2011) "Competitive Targeted Advertising with Price Discrimination", (working paper) [Online]. Available at: <http://ideas.repec.org/p/nip/nipewp/08-2011.html> [Accessed at 11 December 2013]. Esteves and Resende contrast their results when low advertising costs are assumed with disputed studies over whether, in cases of more costly conventional advertising, targeted advertising increases profits. See Ben Elhadj-Ben Brahim, N., Lahmandi-Ayed, R. and Laussel, D. (2010) "Is targeted advertising always beneficial?" (working paper) ("When the advertising cost is high, targeting reduces firms' profits relative to random advertising.") [Online]. Available at: http://www.tn.refer.org/CEAFE/Papiers_CEAFE10/Eco_indus2/Belhadj.pdf [Accessed 11 December 2013] versus Iyer, G., Soberman, D., and Villas-Boas, J. M. (2005) "The Targeting of Advertising", *Marketing Science*, 24(3). pp. 461-476 ("the targeting of advertising increases equilibrium profits.")

14 Esteves, R. and Resende, J. (2011) "Competitive Targeted Advertising with Price Discrimination", (working paper) [Online]. Available at: <http://ideas.repec.org/p/nip/nipewp/08-2011.html> [Accessed 11 December 2013]. p.1 ("price discrimination through targeted advertising may be detrimental to social welfare since it boosts industry profits at the expense of consumer surplus.")



One implication of their models is that “average prices with mass advertising (non-discrimination) are below those with targeted advertising”, which follows the idea that firms will target certain consumers with promotions while enjoying higher prices paid by those “myopic” consumers unaware of discounts offered to others.¹⁵

In this way, user profiling for advertisers allows predatory marketing, comparable to the behaviour observed in the subprime housing bubble globally and in a range of other sectors. Online profiling based on user data allows seedier companies, from subprime mortgage lenders to payday lenders, to target the most naïve and vulnerable potential consumers and facilitates new forms of price discrimination that allows companies to extract the highest potential price for goods and services from each customer.

Early Internet visionary Jaron Lanier, who pioneered ideas like “virtual reality” two decades ago, noted that the “dignified side of capitalism” is less likely to exploit such access to behavioural targeting than the “tawdry” kinds of firms, which “tend to be a lot of ambulance chasers and snake oil salesmen.”¹⁶ The danger is new ways to discriminate based on race or other proxies for exploitable status in society. According to WordStream, a company specializing in helping companies bid effectively on Google Ads, the three most expensive categories of keyword searches as measured by cost per click are in financial services (insurance, loans and mortgages), with 45.6% of the top 10,000 advertising keywords falling in those categories.¹⁷

In fact, Google advertising was a prime beneficiary of and helped facilitate the price discrimination fuelling much of the subprime mortgage destruction of family wealth and the financial crisis that followed. As Jeff Chester of the Centre for Digital Democracy detailed back in 2007, “Many online companies depend for a disproportionate amount of their income on financial services advertising, with subprime in some cases accounting for a large part of it.”¹⁸ And Google continued to facilitate scam mortgage “loan modification” advertisers targeting the victims of the financial meltdown¹⁹ until the United States Treasury Department took regulatory action under its TARP authority to shut down 85 of these scam advertisers who were luring customers through the search engine.

No-one can deny the economic and social revolution that the Internet has created. And the pace of change continues and every day uncovers new possibilities for businesses and wider society. But this does not mean that the rise of big data and information sharing should be a runaway train – this risks unintended harm to consumers and a more pervasive increase in economic inequality.

Government authorities using antitrust and other regulatory tools can stem at least part of this trend by restoring a degree of control to individuals over what personal data is shared online and the financial terms on which that data is shared. This in turn can eliminate some of the information-based inequality in the modern marketplace that is driving the overall economic inequality. While antitrust investigations in the U.S. and Europe have overwhelmingly focused on how the company displays search results, a reorientation of the antitrust investigation of Google and other companies to focus on how they mine personal data can, if nothing else, be a chance for a much broader public debate on the abuses of data mining online and how to make all markets work more fairly for average working families.

15 Esteves, R. and Resende, J. (2011) “Competitive Targeted Advertising with Price Discrimination”, (working paper) [Online]. Available at: <http://ideas.repec.org/p/nip/nipewp/08-2011.html> [Accessed 11 December 2013].28.

16 Brockman, J. (2011) “The Local-Global Flip, or, “The Lanier Effect”: A Conversation with Jaron Lanier.” *Edge* [Online]. Available at: <http://edge.org/conversation/the-local-global-flip>

17 Kim, L. (2011) “The Most Expensive Keywords in Google AdWords”, *Wordstream Blog* [Online]. Available at: <http://www.wordstream.com/blog/ws/2011/07/18/most-expensive-google-adwords-keywords>.democraticmedia.org/jcblog/?p=349 [Accessed 11 December 2013].



Section Two

The Contradictions of Modern Markets

2



Culture and the Good Corporation

Professor Roger Steare, Cass Business School

"Culture" became the buzzword on everyone's lips during 2012 as the Libor scandal broke and financial markets were rocked – yet again. Bank chairmen, politicians and the media have now agreed that despite massive regulation for over a decade, the behaviour of a minority of leaders and employees continues to breach the norms that society expects of those we trust with our pensions, mortgages and bank accounts. And yet it is my experience that very few leaders in banking – and in indeed in many other industries – have a clear idea what we mean by culture, what we mean by a good culture and what we mean by a good corporate culture.

The Latin roots of the word "culture" allude to growth, development, and sustainability. For the human race, it also describes our ability to use relationships and rituals to work together in complex groups, to use language to learn with and from each other, and to use tools to shape and control physical resources and the environment.

In terms of relationships, the basic forms of family, friendship and tribe have enabled us to prosper as a species. Whilst we are still capable of appalling behaviour within these groups, we have developed a fundamental set of norms and taboos that seem to work well for most of the time and make up the fabric of our morality. This is based primarily on an ethic of care (essential for the nurture of offspring); an ethic of obedience (prescribed by norms and taboos, and reinforced by reward or punishment); and an ethic of reason (for example, our ability to make complex logical decisions about the fair distribution of resources)¹. These beliefs, norms and taboos are then embedded into our behaviours through rituals. In religion, these rituals include the way we meditate and worship. In business, these rituals include the way we treat our customers and each other in meetings, on calls and in emails.

The other variable in which these relationships are situated is the distribution of influence and power, what we call politics. Again there is still significant variation in the forms this has taken, but the trend over the last few hundred years has been a recognition that democracy, in Churchill's words, "is the least worst form of government". In a functional democracy, our children will be nurtured and educated; our ability to communicate openly is encouraged; and we are able to stimulate the creativity and ingenuity to develop new, transformational technologies.

1 Churchland, P. (2011), *Braintrust*, Princeton University Press: Princeton.

Modern Day Feudalism

Unfortunately, the modern corporation is a relic of feudal thinking. Created and developed by the British and the Dutch in the seventeenth century, power within the corporation ultimately derives from wealth. It is a plutocracy. As such corporations are more like feudal monarchies than the democracies within which they operate and from whom they derive their licence to operate. Power in the corporation is about command and control. The language and symbology used is the language of violence: strategies are executed; people are terminated; and you hear phrases like “keep your head down or it’ll get chopped off”. CEOs are the monarchs of the corporation. Transient senior leaders are the mercenaries that fight the “art of war” in business. Workers and customers are peasants who can be exploited and abused at the whim of the executive aristocracy.

If this analogy seems too extreme, let’s consider some of the research in support of this proposition. Joel Bakan’s *The Corporation*² is a meta-study of corporate failure, his basic hypothesis being that corporate culture is defined more by psychopathy than by empathy. Human beings and our biosphere are to be harmed or sacrificed in the pursuit of profit. Corporate scams such as the mis-selling of PPI are commonplace. The public are targeted and manipulated as consumers. As Nathan Newman discusses elsewhere in this collection, a number of companies such as Apple, Google and British Airways have been subject to civil action following collusion with other market actors to manipulate prices and influence consumer habits. Pharmaceutical companies have targeted adult anti-depressants at children with fatal consequences. Oil companies have exploited and polluted both society and the environment. Every day the news adds more examples to this list.

Meanwhile, other research shows how good people become more compliant and less empathic when they show up at work. I have developed a psychometric tool called the MoralDNA™ Profile³ that measures our preferences for the aforementioned ethics of obedience, care and reason. This profile is now being extensively used in several major corporations to measure culture, both at the level of personal preferences and in terms of collective cultural norms. In an aggregation of the MoralDNA™ Profiles of business executives from a number of these corporations the results show how our fear-driven ethic of obedience increases when we come to work and our ethic of care decreases. When good people feel that doing the right thing is just to follow orders without caring about the consequences for other people, we call this brutality.

Recalibrating cultures in the good corporation

There is an emerging group of corporations who have either avoided or transformed this command-and-control, fear driven, psychopathic culture. Raj Sisodia, author of *Firms of Endearment*, identifies companies that display both high performance *and* cultures which underscore a clear purpose to serve society⁴. Representing an “emotional contract” between all stakeholders, they are able to reconcile fairly the interests of customers, shareholders, employees and local communities. Executive pay is modest. Their values drive good decision-making and innovation. They care about the environment.⁵ These firms not only have cultures based on clear purpose, vision and values, they significantly outperform their competitors. As a group, they have outperformed the S&P 500 by an average of 8:1 over a 10-year period.

A cultural transformation from feudalism to humanism does not require a massive investment – it actually reduces costs because corporate feudalism multiplies the massive overheads of hierarchy, bureaucracy and complexity. Change can be rapid, but it is not a project with a beginning and an end. It is a constant. And we know how to do it, because we already know how to live as families, friends, neighbours and good citizens.

2 ²⁷ Bakan, J. (2004) *The corporation: Pathological pursuit of profit and power*, London: Constable.

3 www.MoralDNA.org

4 Sisodia, R. *et al.* (2007), *Firms of Endearment*, Prentice Hall.

5 Sisodia, R. *et al.* (2007), *Firms of Endearment*, Prentice Hall.



In the work I'm currently doing with several global corporations in the banking, energy, retail and engineering sectors, the questions that I ask business leaders to ask and answer – both for themselves as individuals and for their businesses – are these: Firstly, why do you exist, what is your purpose and how will you sustain it? Secondly, who are you, what are your values and how do people describe your character? Thirdly, how do you make difficult decisions in the moments that matter, and do you understand your personal preferences, prejudices and biases? And finally, how do you act, how do others perceive your behaviour and do your actions sustain your purpose?

These four sets of questions form a virtuous circle or moral compass that is the symbol not for what management consultants might describe as a linear, finite “culture change project”, but as a system, a sustainable eco-system for the culture of a good business.

After asking and answering these questions, the responsibility of good business leaders is to lead by example, to “be the change you want to see” as Gandhi once said. Leadership is the single most powerful driver of culture, values and behaviour. But it is also important to change what we might call the cultural levers or “reinforcers” that support this cultural eco-system. These “reinforcers” include learning and development; open communication systems; fair performance management and reward systems; and celebrations of success when people do the right thing.

But this also requires a change of culture in society, in politics, in regulation and in the media. Bad corporate culture is a reflection of the dark side in all of us. Consumer capitalism is the dark energy that feeds corporate wrongdoing and excess. When do any of us challenge the assumptions that our purpose in life is to have whatever we want, whenever we want it? Why do we assume that the politics and economics of unlimited growth are sustainable in a fragile, closed eco-system? When was the last time we looked in the mirror before we pointed the finger at the corporate villain?

So in conclusion, in order to fix corporate culture, we also need to fix ourselves. We need to ask our politicians, our regulators, our media and ourselves those same philosophical questions in our moral compass. Only when we can all understand why we exist, who we are, how we make tough decisions, and how we act, can we sustain culture in every part of life and work.

Passive Consumers or Market Players? The Case for Bank Account Portability

Andrea Leadsom MP

As others have highlighted in this collection, one of the most significant crises in modern business is the decline of trust in the banking industry and wider financial services. Small businesses are finding credit hard to come by, taxpayers are angry at the billions spent on the bailouts, products have been mis-sold and indicators manipulated, pay for bankers is often unrelated to performance, and customer service levels are poor.

One of the most striking aspects of the financial crisis, and more recent scandals such as LIBOR, was the impotence that ordinary people felt when faced with a tableau of institutional failure. Much has been made of the regulatory shortcomings that have contributed to these problems, and public opinion often reflects the actions of government and regulators. However little attention has been directed at the competitive environment itself. And a competitive market is one of the best ways to ensure these problems are not repeated.

Changing the rules of the game

Providing the environment to enable full, and instantaneous, full bank account number portability would be a game changer in UK finance. It should be as easy for someone to change their bank account as it is for them to change their mobile phone provider. Only full bank account number portability (ANP) would make this a reality – the current account switching service (CASS) or 7-day switching advocated by the Payments Council and endorsed by the Independent Commission on Banking recently introduced does not.

7-day switching should be part of the journey towards ANP but it is not itself the destination. The Government are warm to this idea and are moving in the right direction. Earlier this year the Treasury launched a consultation looking at the UK payments systems with a view to encouraging greater competition and consumer choice. The Government's recent response to the consultation, "Opening Up UK Payments", states its intention to establish a utility-style payments regulator under the authority of the Financial Conduct Authority (FCA) which will have the power to promote competition, innovation and benefits for customers. One of the first jobs of the regulator, which should be established by spring 2015, will be to complete a cost benefit analysis of ANP. This should pave the way for ANP to be introduced with a long lead time, to tie in with the timetable for the retail ring fence.

Giving personal and business customers the ability to switch instantly would be a massive boost for consumer choice. It would dramatically improve the competitive outlook in UK banking – new entrants would be encouraged, as would product innovation; the "too big to fail" risk would be greatly reduced. Resolution of failed banks would be transformed as the Regulator (now the Bank of England) would be able to shut down a failing bank whilst avoiding the risk of a run on the banks – because all personal and business accounts could be instantly transferred to survivor banks.

New proposals from technology specialists indicate that this would not be an expensive system to introduce. And it would have remarkable benefits.



Cultivating a climate for consumer choice

The Independent Commission on Banking (ICB), led by Sir John Vickers, concurred that there was an issue that needed to be addressed, stating in its final report:

“Competition between banks is blunted by the actual and perceived difficulties for customers in identifying the right account for their needs and switching to it, and by poor conditions for consumer choice more generally. Without consumers being willing to switch between competitors, banks have weak incentives to provide better offers.”

The ICB reported that there was a switching rate of just 3.8 per cent for personal current accounts in 2010, that three-quarters of consumers have never considered switching their current account, that 51 per cent of small to medium-sized businesses had never switched their main banking relationship and that 85 per cent of businesses surveyed by the Federation of Small Businesses had not switched their main banking provider in three years.

These switching rates compare unfavourably with other industries. 15 per cent of consumers changes their gas supplier in 2010 and 17 per cent switched electricity supplier in the same year. Moreover, 26 per cent of consumers switched telephone provider 22 per cent changed insurance provider in 2010.

The market is not adequately producing competition. The ICB found that various banking markets “are considerably more concentrated than any point over the previous decade, and the number of challengers has fallen sharply”.

An idea whose time has come

The Parliamentary Commission on Banking Standards (PCBS), set up after the revelations of Libor fixing, has looked again at the issue of ANP. It is supportive of the idea but, as the Treasury Select Committee also concluded in 2012, not enough work has been done on the cost of implementing ANP.

Making it easier for people to switch bank provider is not a new concept. Sir Don Cruikshank, who led a review of the banking sector published in 2000, has long been committed to the idea of full bank account number portability.

However, in 2001 the Office of Fair Trading asserted that introducing portable account numbers would “require major investment and significant changes to the operation of the current clearing systems. As the inconvenience of changing account numbers is only one of many constraints on switching, the costs of such a development are very likely to exceed the benefit”. As we will see, this finding is now out of date.

The ICB called for a system that would make account switching easier. However, the ICB’s final proposals, published in September 2011, stopped short of full bank account number portability.

The ICB determined that what was necessary was a redirection service for personal and small business accounts that: caught all credits and debits going to the old account (including automated payments); was “seamless” and “problem-free” for the customer (including guaranteed no losses if mistakes were made); sent reminders to direct debit originators that details were updated; and was free to the customer. The ICB believed this new system should be up and running by September 2013.

The Treasury Select Committee (TSC) took evidence on the ICB interim and final reports, in which several people said that account switching was important. The TSC found that the ICB’s interim report had not given adequate consideration to account number switching and transparency, having devoted just one page to the topic.

At a roundtable discussion in the House of Commons on 13 September 2012, representatives from the Bank of England, Lloyds, RBS, Barclays, HSBC, Metro Bank, Virgin Money, the Treasury Select Committee the Payments Council, Vocalink and the British Bankers Association discussed the idea of full bank account number portability.

Former Royal Bank of Scotland Chief Executive Stephen Hester sent the following message to participants in that discussion:

“RBS supports competition in banking markets. We support moves to improve, speed up and simplify current account switching for retail customers. There are important technical challenges but these should be treated as issues to constructively work through not insoluble blockers to the end goal. The principle should be that if a customer wants to leave or join us, unreasonable obstacles should not be put in their way.”

Following that event, Which? Executive Director Richard Lloyd said:

“One of the most important ways that consumers can influence the broken banking culture in this country is by voting with their feet and switching to another bank. Yet half of consumers have never changed current accounts.

“With consumer trust in banking at an all-time low, we want to see banks up their game and put customers first. We urge the Government to seriously look at introducing portable account numbers to make switching easier for consumers.”

The advantages of ANP

A truly competitive environment requires “free entry” and “free exit” of market players. This is not the situation with banking in this country. Rather the trend has been towards consolidation and mergers. A small number of very large banks dominate. In 2000 there were 41 major British banking groups and subsidiaries, in 2010 there were just 22. Four banks have an almost 80 per cent market share of the personal current account and small and medium enterprise lending market.¹ Therefore there is evidently a need for genuinely comprehensive action.

The Government should be aiming for full bank account number portability to be achieved in the next ten years. Banks would need to establish a clearing system in common, which would hold all bank accounts with an identifying code to establish which commercial bank has the account.

Several benefits would accrue from this policy. The ability to retain their account number would make it easier and more attractive to encourage customers to change provider. The possibility of almost instantaneous switching would result in much greater competition between banks. Any newly authorised bank would be able to buy a licence to use the system, which would be a boost to challenger banks and take away the unfair advantage enjoyed by long-established clearers.

Accounts could be easily transferred from failed institutions to sound ones, which set in the context of a future financial collapse or potential run on a bank is obviously an additional massive plus for full bank account number portability as it would obviate the potential need for a bailout.

At the roundtable discussion in the House of Commons on 13 September 2012, Andy Haldane, Executive Director, Financial Stability of the Bank of England said that “introducing account portability would help to compete away the problem of too big to fail rather than having to regulate it away.”²

From theory to practice

Intellect, which represents the UK technology industry, outlines how the system could work in its recent report “Biting the Bullet”: The principle enabler facilitating the account portability is the centralised storage of payment mandate information (direct debits, standing orders) and unique consumer identifiers that will be held in the Central Utility. Both account switching and mass account migration become a case of simply changing the specific target current account

1 British Bankers’ Association (2010) *Annual Abstract of Statistics*

2 House of Commons (2013) *Banking Standards – Written evidence from Andrea Leadsom MP* [Online]. Available at: http://www.publications.parliament.uk/pa/jt201314/jtselect/jtpebs/27/27v_we05.htm#footnote_30 [Accessed 11 December 2013].



data, rather than a process of re-establishing all of the mandates associated with a consumer's account. Similarly, receivables directed to the consumer's account (such as their salary or pension) will not require alteration, as they will be referencing the unique consumer identifier. They will therefore continue to function normally when the underlying target current account associated with the consumer's unique identifier is switched to a new provider.

In effect, all account information relating to a specific individual or business will "hang" from a unique identifier – in essence a portable number that will be retained by that individual/business on an ongoing basis.

New research by Vocalink, who operate the UK national payments infrastructure, indicates that it would not be prohibitively expensive to introduce a new system to enable instantaneous switching.

Analysis of the precise likely costs needs to be carried out as a matter of urgency, but previous concerns that it would of necessity require the upgrading of banks' legacy systems appear to be misplaced.

Intellect suggests that the costs of the system could be borne by a small annual subscription from each account holder. In effect, the barriers to action are low.

It is encouraging that the Government is moving towards ANP. It could be achieved within the next ten years and banks should consider factoring it in to their planning. It is clear that the ICB, PCBS and now the Government acknowledge that this is a road we do need to take.

Full bank account number portability would be good for the consumer and good for challenger banks. It would also be good for established banks – they should have nothing to fear from it being easier for customers to switch. The appalling scenes we witnessed only too recently of a run on a bank would be a thing of the past, and a sector which currently lies at rock bottom in public opinion would be able to thrive, responsibly, as it has not done for some time.

Now is not the time for timidity, nor is it the time for false economies. This is a policy objective which would enable power to remain with the market without undue intervention from regulators and legislators. Rather it is the duty of these groups to create the climate for better and more effective competition, changing the rules of the game to change the way that players – both institutions and their consumers – behave.

Meet the New Economy

Simon Caulkin, Fellow, ResPublica

At first glance, few people would question the mojo of a world economy being tugged along by new economy titans such as Google, Apple, Facebook and Amazon. Between them these four upstarts have upended whole industries, in the process revolutionising (for once an accurate term) the way we work, communicate, consume and relate to each other. Together, they boast annual revenues of \$280 billion, profits of \$40 billion and a combined market capitalisation of over \$1trillion.¹ By any standards these are energetic, innovative companies that are reaping handsome rewards for doing what they do extremely well. Yet the complete picture of “what they do” is more complicated. Unpicked, their success is not the simple story of free-enterprise capitalism that the official narrative proposes. And while financial benefits have flowed to shareholders and top employees from their undoubted commercial achievements, those benefits are not only not shared, they have come at considerable cost to the rest of the population. The strength of the individual companies is not matched at the level of national economies, where growth obstinately refuses to return, well-paid jobs for the middle classes are lacking, and competitiveness and innovation flag. Counterintuitively, the two things are linked. Companies lauded as new economy heroes are actually much more ambiguous characters. In the aggregate, they are more value extractors than value creators, holding back growth, stunting innovation and promoting inequality across the whole economy.

How has this come about? For a start, as revisionists point out, there is something wrong with the story of Steve Jobs, Sergey Brin and Jeff Bezos as lone entrepreneurs taming the frontiers of innovation through individual persistence and vision alone. Of course, they could not have succeeded without possessing those qualities in high degree. But simplified out is the complex systems aspect of the innovation process, at both micro and macro level. While the received account enhances up the role of entrepreneurs and venture capital, it airbrushes out the enabling role of the state. In their paper “The Risk-Reward Nexus”, academics William Lazonick and Mariana Mazzucato note that the algorithms used in Google’s

1 For Apple, (2013) “Apple Reports Fourth Quarter Results” *Apple* [Online]. Available at: <http://www.apple.com/uk/pr/library/2013/10/28Apple-Reports-Fourth-Quarter-Results.html>; “Apple Inc. (AAPL) NasdaqGS” (2013) *Yahoo! Finance* <http://uk.finance.yahoo.com/q?s=AAPL>. For Google, (2013) “Google Inc. Announces Third Quarter 2013 Results” *Google: Investor Relations* [Online]. Available at: http://investor.google.com/earnings/2013/Q3_google_earnings.html; BBC (2013) “Google profits boost share price” *BBC News* 18 October 2013 [Online]. Available at <http://www.bbc.co.uk/news/business-24576694>; “Google Inc. (GOOG) NasdaqGS” (2013) *Yahoo! Finance* <http://uk.finance.yahoo.com/q?s=GOOG>. For Facebook, BBC (2013) “Facebook revenue surges 60% on strong ad sales” *BBC News* 31 October 2013 [Online]. Available at <http://www.bbc.co.uk/news/business-24751441>; “Facebook, Inc. (FB) NasdaqGS” (2013) *Yahoo! Finance* [Online]. Available at: <http://uk.finance.yahoo.com/q?s=FB>. For Amazon, Streitfeld, D. (2013) “Amazon’s revenue soars, but no profit in sight”, *New York Times* 24 October 2013 [Online]. Available at: http://www.nytimes.com/2013/10/25/technology/amazons-revenue-soars-but-no-profit-in-sight.html?_r=0ff; “Amazon.com Inc (AMZN)” (2013) *Yahoo! Finance* [Online]. Available at: <http://uk.finance.yahoo.com/q?s=AMZN>. [All accessed 11 December 2013]



search engine and some of the technologies in the Apple iPhone came out of publicly-funded rather than private research². The Internet, the essential enabler for all four firms' expansion, was also the product of government, in this case defence and research spending. So was nanotechnology. The US National Institutes of Health currently spend \$30 billion a year, double the real levels of the 1990s, to develop the biotech industry and biopharmaceutical knowledge base, without which "the US, and probably the world would not have a biopharmaceutical industry," according to the authors.

Other writers have made the point that sustained and heavy government investment, particularly at the riskiest and most uncertain stages, has played an important part in the development of every one of the general purpose technologies (GPTs) – mass production, aviation, space, IT, nuclear power and the Internet – that have been the engine of economic growth over the last century.

Putting this in a different way: the risks and rewards applying to the different economic actors in the innovation process are out of sync, in both time and space. Increasingly, risk-bearers and reward-takers are different people, the benefits disproportionately accruing to a few opportunist firms and venture capitalists that have positioned themselves under the public innovation spigot, after the early risks have been taken, ready to pocket the spoils by taking the innovation to market.

Good luck to them, you might say – that's capitalism. Yes: provided that the winners use their luck, and undoubted smartness, to sustain what we might call the overall innovation architecture. But too few of them do. In an article for *Fortune*, Jan Rivkin and strategy doyen Michael Porter charge that businesses have contributed to the problems of declining competitiveness and faltering growth by underrating the importance of the industrial "commons"³. Competitiveness, they say, means not only competing successfully in the global economy, but also sustaining high and rising living standards for the average citizen – "doing one without the other means we aren't really competitive". In turn, that means being more innovative, building supportive rather than adversarial supply chains and "stopping self-interested actions that weaken the commons": notably lobbying and demanding exemptions and tax breaks on one side, while also calling for continuing government support for R&D on the other.

Although Porter doesn't spell it out, "self-interest" here has a particular sense. The justification for companies' neglect of the innovation commons – for scooping the rewards of public investment in innovation while minimising their contribution to it – is that they thereby maximise returns to shareholders. As Lazonick has shown, claiming absolution from the hard work of building their own human and intellectual capital by publicly funded research has allowed them to ramp up rewards to shareholders to a truly remarkable degree. In the past, that is, up to the early 1980s, in allocating corporate resources company executives largely followed a strategy of "retain and reinvest" – using profits to pay dividends, but also to finance expansion and R&D that in the long term would benefit all stakeholders, employees and suppliers as well as shareholders. When the ideology of shareholder-value maximisation took hold in the 1980s, resource-allocation switched 180 degrees. With all corporate resources now devoted to increasing earnings to boost share prices, "downsize and distribute" was the order of the day. Mass layoffs to increase profits, outsourcing production to lower-wage economies and slashing R&D became the norm.

Meanwhile, payments to shareholders went through the roof. In the decade 2001-2010, Lazonick calculates that S&P 500 companies distributed \$1.9 trillion in dividends, equivalent to 40 per cent of their combined net income, and spent another \$2.6 trillion, or 54 per cent of income, on share buybacks, a ploy whose sole function is to push share prices higher.⁴ Far from being exceptions, high-tech firms whose lifeblood is innovation were in the vanguard. In the years before they had to go cap in hand to governments for rescue, the banks too were lavish repurchasers of their own stock. Among the most conspicuous beneficiaries of this largesse, of course, were those responsible for allocating resources in this way: executives being paid with share options as a means of aligning their interests with those of shareholders. Look no further for the source of today's soaring wealth inequalities, together with the demise of final-

2 Lazonick, W. and Mazzucato, M. (2012) "The Risk-Reward Nexus: Innovation, Finance and Inclusive Growth" *Policy Network* [Online]. Available at: <http://www.policy-network.net/publications/4295/The-Risk-Reward-Nexus>. [Accessed 11 December 2013].

3 Porter, M. and Rivkin, J. (2012) "What business should do to restore competitiveness", *Fortune*.

4 Lazonick, W. and Mazzucato, M. (2012) "The Risk-Reward Nexus: Innovation, Finance and Inclusive Growth" *Policy Network* [Online]. Available at: <http://www.policy-network.net/publications/4295/The-Risk-Reward-Nexus>. [Accessed 11 December 2013], p.25.

salary pensions and the end of employment security – all of them creeping casualties of systematic cost-cutting for the benefit of shareholders and their senior management proxies. Self-interest indeed.

The resource allocation switch driven by the shareholder-value ideology goes a long way towards explaining why, despite untold billions spent on stimulus, the economies of the US and UK, where the received wisdom is most unquestioningly accepted, have been treading water. Innovation guru Clayton Christensen notes that in seven recoveries from recession between 1948 and 1981, the economy took six months to return to pre-recession employment levels. In 1990 on the other hand the recovery took 15 months, in 2001 39 months. This time the gears have been grinding for more than five years and a return to previous peak performance levels in countries like the UK is still a long way off⁵. Some commentators are now evoking the dread possibility that underlying growth itself is coming to an end.

It doesn't seem to help when companies and private equity funds are stuffed with unspent cash. (At the time of writing Apple alone had a stash of nearly \$150 billion.) "Capitalists seem almost uninterested in capitalism," laments Christensen – and he too fingers as culprit "the doctrine of new finance", which deters investment in growth-creating empowering innovations and channels it instead into risk-free efficiency gains that cut jobs rather than create them. The trouble is that after three decades of outsourcing and cost-cutting the US no longer possesses the means of creating the next generation of innovative products, according to Gary Pisano and Willy Shih in a much-noted *Harvard Business Review* article, "Restoring American Competitiveness"⁶. Amazon couldn't manufacture its Kindle in the US if it wanted to. The UK, even more skewed towards the bankrupt financial sector than the US, is even more hollowed out. In the 21st century, the UK's largest manufacturing sector is food-processing.

As all the above demonstrates, the idea that there is something economically and socially distinct in fast-moving, Internet-enabled, New Economy companies is mistaken. Being smart and innovative is important. But if they are not creating what Umair Haque calls "thick value" – that is, new real economic value that that is not just captured from customers and suppliers – then they are part of the problem, not the solution. And if they don't spend their corporate cash piles to devise new products of real value, create good domestic jobs and otherwise maintain the commons, it's not because they can't but because they don't want to. Despite its monumental margins, Apple creates no manufacturing jobs in the US (although it is now talking of doing so) and has rightly attracted criticism for working conditions at its manufacturing supply plants in China. Facebook and Google are accused of extracting profit by unscrupulous exploitation of personal information. Amazon pays UK warehouse workers less than a living wage (albeit with some shares and a pension). All four are under fire for tax arrangements that minimise their contribution to the social and economic infrastructure. It's been done before; unless and until the incentives governing the allocation of corporate resources are altered to favour the broader society rather than shareholders alone, the refrain won't change. Meet the New Economy, same as the Old Economy.

5 Christensen, C. M. (2012) "A capitalist's dilemma, whoever wins on Tuesday", *New York Times*.

6 Pisano, G. P. and Shih, W. C. (2009) "Restoring American competitiveness", *Harvard Business Review*.

Are Governance and Innovation a Contradiction in Terms?

Dr Eric Jackson, Commentator, Forbes

The rise of the web gorillas such as Facebook and Google has marked an unprecedented pace of change. Silicon Valley, as the cradle of global innovation, has cultivated some of the greatest technology innovations. Its legacy will always be Apple, Intel, Google and now Facebook. But innovation does not imply infallibility. On the contrary, the pace of change of the "new economy" sector also has implications for corporate governance. In attempting to address competitive pressures, companies are in danger of succumbing to those archaic and paranoid structures which limit innovation itself.

Marking the pace of change

Over the years we have seen three generations of Internet companies. Web 1.0 encompassed companies founded from 1994 to 2001, including Netscape, Yahoo! AOL, Google, Amazon and eBay. From there emerged Web 2.0 or the social companies founded from 2002 to 2009, including Facebook, LinkedIn, and Groupon. And more recently, mobile web, such as Instagram, from 2010 to the present.

With each succeeding generation in the Internet, it seems the prior generation can't quite wrap its head around the subtle changes that the next generation bring. Web 1.0 companies did a great job of aggregating data and presenting it in an easy to digest portal fashion. When Web 2.0 companies began to emerge, they seemed to gravitate to the importance of social connections. MySpace built a network of people with a passion for music initially. Facebook got college students. LinkedIn got the white collar professionals. Digg, Reddit, and StumbleUpon showed how users could generate content themselves and make the overall community more valuable.

Yet, Web 1.0 companies never really seemed to be able to grasp the importance of building a social community and tapping into the backgrounds of those users. Even when it seems painfully obvious to everyone, there just doesn't seem to be the capacity of these older companies to shift to a new paradigm. Why has Amazon done so little in social? And Google? Even as they pour billions at the problem, their primary business model which made them successful in the first place seems to override their expansion into some new way of thinking.

Mobile companies born since 2010 have a very different view of the world. These companies view the mobile smartphone as the primary (and oftentimes exclusive) platform for their application. They don't even think of launching via a web site. They assume, over time, people will use their mobile applications almost entirely instead of websites. Web 1.0 and 2.0 companies still seem unsure how to adapt to this new paradigm.

The organizational ecologists talked about the “liability of obsolescence” which is a growing mismatch between an organization’s inherent product strategy and its operating environment over time. This probably is a good explanation for what we’re seeing in the tech world today.

But with each new paradigm shift (first to social, now to mobile, and next to whatever else), the older generations get increasingly out of touch and likely closer to their significant decline. What’s more, the tech world in which we live in seems to be speeding up.

With the rate that the tech world is moving these days, there are good reasons to think both Google and Facebook could be shells of themselves in the next 5 years – or gone completely. Not bankrupt gone, but MySpace gone. In all likelihood, we could have an entirely new way of gathering information and interacting with ads in a new mobile world than what we’re currently used to today. Several Web 1.0 and 2.0 companies might be completely wiped off the map by then. Those who own the future are going to be the ones who create it. It’s all up for grabs.

“Innovation” at the expense of accountability: The Google case

Web monopolies are not as sticky as the monopolies of old. The fact that Google’s stock price first hit \$600 in 2007 and it’s still trading there now, and that it is trading 11% below its all-time high, is telling. The fact that Apple’s stock is up 587% in the last 5 years while Google’s is up 37% (a difference of 16x) also is indicative of the increasing competitive pressures in a constantly evolving tech sector.¹

No one can perfectly predict the future 5-8 years from now. But, from where I sit, Google is severely threatened by this rapid shift to mobile from the good old days of the desktop search world. If search queries keep going flat and then actually start declining in a couple of years, expect an HP-sized correction in Google’s stock price. And watch for signs of “Ask Siri” taking over in the vernacular for “Google It.”

The Google co-founders, Larry Page and Sergey Brin, are now 40, and I am sure like to think of themselves as young and hip. However, compared to Mark Zuckerberg and Kevin Systrom of Instagram, Page and Brin are dinosaurs with a lot of bureaucracy and path dependence surrounding them.

In 2012, Google instigated the creation of a triple class structure, to ensure that, even as they use more stock for employee compensation, the founders and Eric Schmidt hold on to full control of the company. There’s nothing really new here. Google has always had this unfounded fear of shareholder accountability going back to their 2004 IPO letter.

“In the transition to public ownership, we have set up a corporate structure that will make it harder for outside parties to take over or influence Google. This structure will also make it easier for our management team to follow the long term, innovative approach emphasized earlier...The main effect of this structure is likely to leave our team, especially Sergey and me, with increasingly significant control over the company’s decisions and fate, as Google shares change hands...New investors will fully share in Google’s long term economic future but will have little ability to influence its strategic decisions through their voting rights...”²

The success of Google’s profits distracts from the fact that the company has done little to “innovate” over the years. Was copying Internet Explorer innovating? Or Yahoo! mail? Or Facebook? Or buying YouTube?

How has Google’s governance structure caused this lack of innovation?

Necessity is the mother of innovation. Larry and Sergey didn’t need “time, stability, and independence” to create Google. Why would they need it now? It sounds great to have the luxury of time and \$49 billion in cash sitting in your bank account. But it can also create complacency, overconfidence, and a false sense of security.

1 Jackson, E. (2012) “Google’s paranoid governance structure has made it less innovative, not more” *Forbes* [Online]. Available at <http://www.forbes.com/sites/ericjackson/2012/04/13/googles-paranoid-governance-structure-has-made-it-less-innovative-not-more/3/> [Accessed 11 December 2013].

2 Brin, S. and Page, L. (2004) “2004 Founders’ IPO Letter” *Google* [Online]. Available at: <http://investor.google.com/corporate/2004/ipo-founders-letter.html> [Accessed 11 December 2013].



To me, these Google co-founders have always seemed unjustifiably fearful of investors banging on their door and holding them accountable. As Brian Sullivan of CNBC tweeted, it would take an activist hedge fund \$10 billion to build a 5% stake in Google.³ That will never happen. Yet, they decided to double-down on this dumb structure.

Beyond “do no evil” this is “do no accountability.” We can also note that the EU antitrust inquiry into Google’s search engine practices is still unresolved after almost five years of scrutiny. After the commission has expressed concern about the company’s use of algorithms to prioritise its own services above those of competitors, the terms of negotiation for a settlement proposal between Google and the European Commission are still deemed “unacceptable” by competitors and commissioners alike³.

Implications for shareholders and governance

Building a 5% stake in Apple is even more unrealistic than doing it in Google. But Apple, to its credit, has much less of an inward looking governance structure. Instead, they have figured out how to “innovate” again and again over decades. With Google, we’re still waiting for that second trick.

Sometimes being spoiled in infancy can stunt personal growth later. You expect to succeed every time you do something. You forget to stop working so hard. You move into areas that are beyond your domain expertise. And, when you fail once, twice, and three times, you blame someone other than yourself for the mistakes.

When the economy crashed in 2008, there was lots of blame to go around but governance models stayed intact. Those who suffered were the retail investors and those who placed faith in the management of big pensions and mutual funds. But shareholders who want accountability are seen as leftist activists, pushing for unions or Amnesty International types on the boards. It is increasingly more difficult for shareholders to unseat crony boards and under-performing CEOs.

We need CEOs and boards who are really accountable. I hope that social media can help bring that about. But Google’s triple class structure will mean a losing outcome for shareholders, whilst blocking rather than opening doors for innovation. Keeping up with the pace of innovation requires a focus on what matters.

3 Sterling, G. (2013) EU: Google Antitrust Concessions “Unacceptable” As Second Study Condemns “Rival Links”, Search Engine Land, Available online at <http://searchengineland.com/eu-google-antitrust-concessions-unacceptable-as-second-study-condemns-rival-links-180407>



Section Three



The Company of Tomorrow

3



In Pursuit of Shared Value: Why Successful Enterprise is Social Enterprise

Chi Onwurah MP

I have fond memories of my first job as a graduate at Nortel, a North American telecoms manufacturer. The company operated on a strong, value driven culture that took collective responsibility for recognising individual merit and promoting everyone's capability whilst behaving responsibly to others.

My managers often quoted the management best seller of the time 'In Search of Excellence' by Tom Peters and Robert Waterman, reissued this year as an eBook. In it, two ex McKinsey consultants described what set truly great companies apart, what was the secret of their success. Their conclusions were many. Autonomy and entrepreneurship and a bias for action were praised, but at the heart, fundamentally and as a prerequisite for everything else, two things set apart great companies. The first: valuing people as partners and as "the primary source of productivity gains". And secondly, shared values: of respect, quality, responsible behaviour and community.

As a result, when I hear commentators saying there is no such thing as morals in business I am reminded of Chomsky's famous sentence "Colourless green ideas sleep furiously." It may be grammatically correct but it is otherwise meaningless.

Values and morals in business

Management theory emphasises the importance of values, and good business practice recognises that organisations formed by, run by and answerable to people cannot function outside a moral framework.

Historically, the formation of limited liability companies was not intended to excuse businesses from morality. Limited financial liability brought with it huge benefits for passive investors. But it was not a limited moral liability. To say that moral judgements should not apply because of the profit motive makes no more sense than saying they should not apply to the individual farmer selling corn in the market who is also seeking a profit. To suggest that businesses do not face choices between doing the right thing and not doing the right thing is entirely false.

Few would argue that the choices businesses make do not have social impact. The question is whether businesses take responsibility for it. Corporate Social Responsibility (CSR) has been too often reduced to agency photos of smiling children in developing countries and seen as whitewash – or greenwash – as a result. When working as an engineer in Nigeria I saw the rotting schools and hospitals built as part of international companies' social responsibility programmes but left without teachers, nurses or students.

But at its origins CSR, or Corporate Citizenship as some now prefer to rebrand it, is an acknowledgement of businesses' civic and social responsibilities. And it can and should be a way of judging corporate behaviours.

This is not an easy task. The great advantage of profit as a measure of success is that it is relatively easy to quantify – at least superficially, since quantifying taxable profit may be more of an art as John Mann MP's piece elsewhere in this collection highlights.

Social responsibility is more complex. The same company may be responsible in some areas and less so in others. As others in this publication have attested, businesses contribute to society in a number of different ways, including investing in people, offering fair remuneration, family support and financial schemes, and encouraging employees to contribute to the wider community and rewarding their contribution to the success of the company. An accurate assessment of "corporate citizenship" needs to reflect a wide range of factors if it is to help consumers and other actors in the market form reasonable judgements about the behaviours of a business, whilst also recognising that the primary objective of most companies is to return a profit.

Implementing shared value

As my colleague and Shadow Secretary of State for Business, Chuka Umunna, has recognised, the challenge for policy makers is to frame the rules of the game so that business which is more socially valuable and sustainable is also most profitable. Sir George Cox, former Director General of the Institute of Directors, led an independent review for Labour on the impact of "Short-Termism" on British Business. The review made a number of recommendations, from procurement policy to corporate governance, to address the short-termism which "curtails ambition, inhibits long-term thinking and provides a disincentive to invest in research, new capabilities, products, training, recruitment and skills. It results in drastic cost-cutting and staff-shedding whenever revenue growth fails to keep up with expectation"¹.

A more long-term approach to doing business is likely to promote a shared value approach with local communities, as businesses and management expect to be around long enough to reap the consequences, both good and bad, of social impact. Corporate structures can also encourage business to contribute more to the communities which support them, such as mutuals, co-operatives and Community Interest Companies (CICs). The increased interest in the "John Lewis model" highlights the changing social landscape for business as does more generally the rise of the social entrepreneurship movement as a growing sector both in the UK and across the world.

As with corporate social responsibility, it can be difficult to measure what success means in the context of social entrepreneurs. And there are other challenges: how to ensure the best allocation of resources without the discipline of the market? How to promote good management? How to provide finance so that the successful projects can be scaled up, without losing the local know-how and commitment which is so essential?

As Shadow Minister for Social Enterprise, I am examining examples from across the world of social entrepreneurs making real social and economic contributions to communities. Social entrepreneurship exists at the cutting edge of both the public and the private sectors and should be characterised by the best qualities of both.

Often there seems to be the view that the public sector has the most to learn in terms of innovation and entrepreneurialism. Indeed, many in the voluntary sector are concerned that an ideological agenda is promoting social enterprise as a means of back door privatisation of the public sector.

I would argue that good business and indeed the majority of businesses have always delivered social value and now, with the changing social agenda, is the time to build on that.

¹ Sir George Cox, 2013, quoted at: <http://www.yourbritain.org.uk/agenda-2015/policy-review/cox-report> [Accessed 11 December 2013].



According to Alex Mitchell, UK President of the G20 Young Entrepreneurs' Alliance and a member of Labour's Small Business Task force, "all businesses, large or small are going to have to become social enterprises in one shape or form. As funding and money from government continues to be cut, business is going to have to step up to the mantle and be part of the solution."²

Corporate social responsibility and social entrepreneurship are also going to be vital for developing the culture of long-term investment and rising wages which we need to tackle the cost of living crisis in the UK.

Increasingly, the businesses I meet are keen to emphasise the good work they do in the UK and abroad. I am equally keen to point out that responsible capitalism is also about how they treat their employees and their tax arrangements.

Certainly it is no longer so common to hear company Chief Financial Officers claim they have a duty *only* to their shareholders. There is greater recognition that the interests of shareholders and other stakeholders such as society and employees align *in the long term*. The outcry over Scottish and Southern's commitment to dividends as the key measure of success suggests a widespread sense that that is no longer acceptable, as well as the belief that business should be looking for something more.

Companies do business, shops are filled with exciting new products designed by highly skilled and innovative people, these products can be left on site overnight, and there is sufficient financial trust for a piece of paper to represent real money in shop tills. The reason for all this is that people have come together to form a society constructed around principles of trust and responsibility: where a legal system, police and street lighting, and education are valued and paid for. Business profits from being part of a well-functioning society. And it has a responsibility to that society of which it is part.

2 Calahane, C. (2012) "All businesses will be social enterprises, says Institute of Directors leader" *The Guardian* [Online]. Available at: <http://www.theguardian.com/social-enterprise-network/2012/nov/27/businesses-social-enterprises> [Accessed 11 December 2013].

Responsible Capitalism in Practice: Leading by Example

Michael Izza, Chief Executive, ICAEW

In the wake of the financial crisis there has been a renewed interest in responsible capitalism.

Some would argue that the risk-taking that led to the crisis demonstrates that the idea is a contradiction in terms. That, given what we now know, regulatory intervention is the only means of ensuring market participants behave.

Can the idea be rescued from the naysayers? I believe it can. In my view, businesses that recognise long-term shareholder value is built on doing the right thing will be the ones that prosper. There does however need to be a fundamental reappraisal of the importance of ethics and integrity.

At its peak, the bank bailouts cost the UK taxpayer nearly £1.162 trillion¹. As we come to terms with the economic impact of what happened we continue to witness irresponsible business at its worst – LIBOR rate-fixing in Britain's banks, telecommunications licences scandals in India and the largest healthcare fraud settlement in US history – to name but three recent examples.

If there is one lesson we need to take from the financial crisis it must be that behaving with integrity makes good business sense. Companies with open and transparent cultures tend to be more successful. They are also better at attracting good people.

The accountancy profession has long subscribed to this view. Understanding what ethical behaviour looks like - how to recognise and do the right thing - is built into the core syllabus you have to take to become a Chartered Accountant. It is also something that is regularly reviewed as part of the continued professional development our members have to undertake.

I believe the code of ethics our members subscribe to could be adopted more widely and that the prize for doing so would be a significant shift towards a more responsible business model. A code formalises values, responsibilities and obligations. It establishes a set of standards on employee behaviour. It reduces risk and addresses how unethical activities can be dealt with. This in turn builds confidence among employees, investors and consumers.

What would such a code look like? I believe it needs to be based on five core principles.

¹ Rogers, S. (2011) "Bank reforms: How much did we bail them out and how much do they still owe?" *The Guardian* [Online]. Available at: <http://www.theguardian.com/news/datablog/2011/nov/12/bank-bailouts-uk-credit-crunch> [Accessed 11 December 2013].



Integrity

Integrity requires employees to be honest in all aspects of their professional and business relationships. It helps to tackle corruption and ensure work is not influenced by self-interest or by the interests of other parties.

In the wake of the Maxwell scandal nearly 20 years ago, the Financial Reporting Council (FRC), the London Stock Exchange and the accountancy profession came together to address standards of financial reporting and accountability – which eventually led to the creation of the UK Corporate Governance Code. The code was conceived at ICAEW's head office – Chartered Accountants' Hall – and has now been replicated across the world.

The code recognised audit as a critical tool in delivering integrity. It suggested that UK-listed company boards establish audit committees whose main functions would be to monitor the integrity of the company's financial statements, and to review and monitor the company's internal controls and activities.

More recently, in his review of Libor, Martin Wheatley recommended that ICAEW should work with the new Libor administration on a code of conduct to promote public confidence and credibility. And injecting integrity into banking is at the centre of Wheatley's proposals.

Objectivity

Objectivity prevents bias, conflict of interest or undue influence by others to override professional or business judgements. This can be applied within any form of business, whether you work in a micro business or a large corporation. More importantly, it keeps the business focus on long-term decision-making rather than short-term gain.

Clear guidance on objectivity can also help to mitigate corruption, insider dealing, and even bribery. With businesses operating in an increasingly globalised environment, this objectivity should also extend to business activities in new markets.

The World Bank's governance and anticorruption initiative supports developing countries in minimising corruption. It has found that the business sector grows significantly faster where corruption is lower and property rights and the rule of law are safeguarded. On average, it can make a difference of about 3% per year in annual growth for the enterprises.² In partnership with the World Bank, my organisation is active in Bangladesh, Botswana and Croatia, among others, to help develop robust accountancy professions to drive their economies. We recognise this work can not only aid growth but help developing economies tackle corruption, bribery and even tax evasion.

Continuing professional development

Continuing professional development supports the maintenance of professional skills that allow employees to do their jobs correctly.

This concept is already applied in today's economy – including within the medical, accountancy and legal professions. But I recognise that this concept can be applied within businesses of all sizes and not just within the professions. Ensuring your workforce has the right levels of skills is an investment in your business.

A 2008 report published by the UK Government suggested that “highly skilled individuals are more likely to generate innovative ideas and to handle innovations, enabling firms to engage in more sophisticated production processes”.³

The report identified links between skills and investment in physical capital: “Firms’ decisions to invest in new capital can be affected by the availability of skilled employees. Deficiencies in workforce skills may therefore act as a constraint on both investment and the ability of firms to innovate, with implications for productivity growth.”⁴

2 Sir George Cox, 2013, quoted at: <http://www.yourbritain.org.uk/agenda-2015/policy-review/cox-report> [Accessed 11 December 2013].

3 Department for Business, Enterprise and Regulatory Reform (2008) *Productivity Indicators*, p.73.

4 Department for Business, Enterprise and Regulatory Reform (2008) *Productivity Indicators*, p.72.

It is therefore crucial not only to have the right staff, but to ensure employees have the skills to support growth, competitiveness and the quality of services that foster long-term sustainability.

Confidentiality

For any company it is important to respect the confidentiality of information acquired as a result of professional and business relationships. Employees should not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose this information.

But an employee should be encouraged to disclose confidential information to third parties when not obliged to do so by law or regulations, if the disclosure can be justified in the public interest. A classic example is Michael Woodford, the former Chief Executive of Tokyo-based Olympus. Woodford blew the whistle on an accounting scandal that saw the company hide nearly \$1.7 billion in investment losses since the 1990s. This not only put shareholders at a disadvantage, but falsely influenced public perception of the viability of the company.

Professionalism

Professionalism requires employees to comply with relevant laws and regulations and avoid any action that discredits their business. Poor professional behaviour can include making exaggerated claims for the services a business is able to offer; qualifications an employee may possess, or experience they have gained; or disparaging references or unsubstantiated comparisons to the work of other colleagues.

Responsible capitalism in practice

The New York-based Ethisphere Institute publishes an annual list of the world's most ethical companies. The list celebrates entities that embed ethical business practices, significantly exceed legal compliance minimums and shape future industry standards by setting best practice. This year Marks and Spencer (M&S) have made the list.

M&S's Plan A is a great example of business ethics in practice – enabling the company to work with customers and suppliers to combat climate change, reduce waste, use sustainable raw materials, trade ethically, and help their customers to lead healthier lifestyles. They recognise the imperative of doing this as good business practice – something ICAEW recognised at the National Business Awards this year.

This recession doesn't mean capitalism has failed. But it does mean it needs to change. A new age of responsible capitalism will put ethical business behaviour, accountability and transparency at its heart.

Taking a positive agenda to policymakers will help avoid knee-jerk over-regulation based on past behaviours. Instead, it will focus attention on building a framework of financial regulation that restores trust in capitalism for the future.

Recovery in economic confidence requires a framework which promotes responsibility. A code of ethics is just one mechanism business can use – it provides a model that places the corporate sector at the service of a much wider community of stakeholders.

The global financial crisis did not mark the end of capitalism, but an evolution. A new age of capitalism where responsibility is underpinned by ethical business behaviour, integrity, accountability and transparency. It is a framework of regulation that restores trust in capitalism and in markets, and one that can come from business.

Future-proofing the Boardroom

Lucy P. Marcus, founder and CEO, Marcus Venture Consulting, Corporate Governance Expert

The board room is going through an extraordinary time of transition. More is being demanded of boards than ever before, and the activities of boards are under greater scrutiny.

Corporate boards no longer operate in a secretive world behind closed doors, beyond the watchful eyes of the public and media. Investors, stakeholders, regulatory bodies, and governments are demanding more transparency and accountability. This increased scrutiny is the result of a greater public understanding of the role boards can and should play. There is growing awareness by investors, employees, and customers of the consequences of boards and board members not asking hard questions, not adding real value to the organization, and not protecting its future health and wealth.

Many question what boards do and if they have the skill, vision, and determination, and indeed any power, to affect the real change necessary in steering organizations and improving their business practices. The answer is that the best boards do. Most organizations have boards, be they in the public or private sector, a FTSE 100 company or an NGO, a university or a utility, and these boards have the power to influence the direction of business, to ensure that organizations are doing what is necessary to operate at its best, and to take real action if the organization is not performing well.

Boards will be judged in the future on their ability to “future proof” their organization, ensuring that their organization has longevity and fortitude and the ability to withstand the vagaries of the marketplace, serving not only those invested in the company today, but the investors and all of the stakeholders of tomorrow. They’ll also be viewed for how well they fulfil and balance their “grounding and stargazing” responsibilities, ensuring the company is addressing its day to day and tactical requirements, while at the same time building a strong organization for the future. Boards will be assessed on whether they simply chase short-term gain or build strong organizations for the long term, and whether the people around the table of the board room complement each other well for the tasks at hand.

The best organizations of all sizes, in the for-profit and not-for-profit sectors alike, have boards with independent chairs who can help mitigate conflicts of interest and ensure that the board acts as an effective oversight body. These boards are composed of truly active, engaged, independent, and interested directors who strive to have the best possible understanding of the business the organization is in, and the one it wants to be in. These boards are diverse in the true sense of the word, not only when it comes to gender but also in terms of professional expertise, sector background, colour, age, international perspective, and more, representing the stakeholders of the business and the environment in which it operates.

Beyond that, the best organizations encourage a climate in which actually having the best people on board can bear fruit. These board rooms are environments in which independent board members are comfortable, and indeed required, to ask hard questions, challenge the status quo, and step up to assist in areas where they can. In such an environment boards are able to discuss a whole range of agenda items that are essential for their organization's short- and long-term success. The role of the board here is to help the organization put the relevant items on its agenda and prioritize without losing sight of the bigger picture of the local and global ecosystem in which they operate.

In times of crisis like the one we are currently experiencing, effective boards help their organization to emerge strengthened and to recognize and seize opportunities for critical innovation and investment in a future of sustainable growth that benefits all stakeholders of the organization.

Greater public and shareholder scrutiny will demand more engagement on the part of board members who, in turn, should actively promote transparency and accountability as a means to ensure that organizations can truly serve their stakeholders' and the public interest.

Grounding and Stargazing

The role of modern corporate boards is the juxtaposition of "grounding and stargazing".

Grounding is about making sure the company fulfils all its legal requirements, manages risks properly and does business in a responsible way. It is about all the vital things we associate with board oversight tasks in corporate governance, compliance and corporate risk.

But with that comes an equally and perhaps even more important role: grounding needs to be complemented by stargazing. This is where a board demonstrates its mettle in making sure their organization is ready and able to expand its horizons, strive to achieve more and stretch itself to become a robust and resilient business that is capable of responding effectively to the unknowns in its future. Stargazing should be a big component of the strategic work a board does.

Both grounding and stargazing require asking questions, looking beyond the obvious and the comfortable, and actively engaging with the organization.

The emphasis in recent years seems to be on the tick-boxing of risk management. In speaking with fellow board members from around the world and across a wide variety of sectors, I've found that concern for risk exposure, coupled with a desire not to appear too meddlesome and the time commitments required to do the job properly, means they sometimes leave too little time room for discussions of strategy.

This is a real loss for organizations of all sizes, as part of the purpose of having independent directors with a broad range of skills is to draw on the knowledge and understanding around the table and the broader perspectives they bring to help propel the organization to new heights.

Grounding is a big part of the vital role of directors – ensuring that companies are managing their risk, fulfilling their requirements, "playing by the rules" and being good corporate citizens. But even when fulfilling that role, strategy needs to play a part. In every audit committee and compensation committee, there must be room for considering what the company can do to push itself that much further to achieve more, and better, things for all its stakeholders.

Most importantly, getting the balance right between the two functions of grounding and stargazing helps to ensure the company is doing what it needs to future proof itself. It requires board members who can think outside the box, and who also know when to get back in the box.



Today's Agendas

The boardroom agenda is going through a reformation. To ensure we are helping organizations future proof themselves, what are some essential things boards and board members need to think about, no matter size, location or sector of the organization? Five areas need an update in the way we as board members think about them: infrastructure, technology, internationalization, communication, and balancing continuity and change.

Infrastructure

Boards must embrace the political, economic and social reality of the way the world is operating today and tomorrow. One of the areas that need a real rethink is building organizations that can operate effectively in a low-carbon economy. The main issues here are about energy consumption and integrating clean tech and sustainability. They apply to all facets of the business: from facilities to building stock and rolling stock; from changing work patterns and practices to the ways in which companies engage with their stakeholders and the local communities where they are based. It touches everything an organization does, how it behaves and how it invests. It means board members need to be asking the questions about how these decisions will impact business five and ten years down the road. Most importantly, it isn't about green-washing or perception; it is fundamentally about how the organization does business.

Technology

At the heart of many issues on the modern board agenda is technological innovation. Technology, thus, is not a stand-alone issue, but an integral part of how effectively and successfully a company can be run. It is not an end in itself, but an instrument that can only prove its worth if it serves a concrete purpose, as Eric Jackson mentions elsewhere in this collection. Coupled with that is the speed at which new technology comes into play and the level of disruption it creates in the process of integrating it into the daily running of a company. For all the importance of disruptive innovation, if "old industries" and the tech sector communicate effectively, understanding each other's needs and coming to grips with the significant benefits that today's technology offers, innovation can be enormously helpful in future proofing companies.

For this potential to be fulfilled, boards must make sure their organization is flexible enough to recognize important technological developments and incorporate them into existing business models.

Internationalization

Regardless of a company's main business or where it is located, its success will ultimately depend on grasping the internationalized environment in which it operates. The world today is politically, socially, and economically inter-connected.

This offers opportunities and poses risks at the same time. Board directors need to be able to think outside the walls of their own corporate boardroom. They need to speak their own language as well as the language of the markets where they want to be; for while the world gets smaller and in some respects more similar, local cultural difference remains and understanding it gives companies a distinct edge.

Corporate boards need to set an example and help implement an agenda that is focused on attracting the best people from anywhere and putting them in a place where they work most productively for the success of the company as a whole.

Communication

No corporate board will be able to implement its modern agenda without effective and dynamic communication, both with its stakeholders (customers, staff, investors, etc.) and within the boardroom.

Within the boardroom, this is about asking the necessary questions and being open to hear the answers, however uncomfortable they might be. Outside the boardroom, communication is about the image and strategy of the company; it is about the methods used to communicate this message, and increasingly so.

A board that sends out a message of a forward-looking, socially and economically responsible, and politically aware strategy and does it by old and new forms of communication also sends a message about the right balance between continuity and change, about the unity of word and deed, demonstrating in action that to which it rhetorically commits.

Balancing Continuity and Change

Embracing new ideas and ways of thinking does not mean completely disregarding the old. Boards will only succeed in their task of future proofing their organizations if they see the connections between the old and new.

This requires casting a critical eye on the old, innovating where fruitful, and integrating new technologies and items on the corporate social responsibility agenda into the tried and tested business practices of corporate governance, risk assessment and finance.

Corporate directors need to understand the purpose, strengths and limitations of existing practices and be willing and able to take steps to address them. The modern board agenda does not disregard “old issues,” it is not driven by short-lived “flavours of the month” or the temptations of every disruptive technology or idea that comes into the room, but is rather guided by the needs and vision of the business. This need for balance requires boardrooms to have a mix of people to ensure a comprehensive and complementary diversity of approach, background and skills.

Stargazing is most effective if it is done from a strong foundation where the nuts and bolts of the company work, and where they are grounded in a solid foundation. This is nowhere more obvious than when it comes to a company's financial stability and sustainability. Past, present and future are a continuum when companies seek opportunities for investment and expansion, when they carefully assess risks connected with either, and as they determine the right level of (not only monetary) compensation for their directors and staff.

Putting a Price on Value

Anthony Kleanthous, Consultant

If we, as a species and a nation, are to thrive long into the future, we must have radical economic reform. Our leaders know it, but, with one or two exceptions, they daren't say it. They would rather believe that we can go on growing indefinitely in a finite world; that markets regulate themselves for the common good; and that technology alone will save us from catastrophic environmental change in our own century. They are wrong on all three counts, but they are not willing to risk their own political necks to lead us in the right direction. A political vacuum exists where leadership should be.

The fatal flaw in our traditional (and prevailing) model of economics is that it ignores the link with the natural world. On the whole, we do not pay for the water, food, fibre, minerals and environmental services that we get from nature, or for the intolerable stresses we put on natural systems of waste processing, climate regulation, flood protection, and so on. So, these natural products and services ("eco-services") are under-priced and over-consumed. Our version of capitalism has mistaken money for value, and growth for development. It has filled our homes and offices with goods, but depleted natural resources and threatened our future success. It has taken its eye off the true sources of value: people; and the natural environment.

We must begin to account for these more fundamental forms of capital, and use their availability and quality as key indicators of economic health, so that their true value is reflected in prices, and distributed efficiently throughout the national and global economies.

It is true that this would drive the price of some activities, such as flying, beyond the means of the average wallet and into the realm of rare luxury. Our responses to these changes will involve debates about what does and does not constitute a "good life", and what kind of a safety net society should provide to those who need help to live sustainably. Free flights to Barcelona for the long-term unemployed? Perhaps not. A high speed, integrated, affordable, accessible rail service linking us with the rest of Europe? Yes, we should have had one long ago.

How we define "the good life" is another way of saying how we define true value. And, as Jules Peck and I argued way back in 2005¹, value itself is changing. For example, the vast majority of people now understand that they have some impact on the world through their consumption habits, and want help to make those impacts as light or beneficial as possible. While infinite growth in the consumption of ecosystem services is out of the question, there need be no let-up in the growth in value. This is the purpose of innovation and design.

1 Kleanthous, A. and Peck J. (2006) *Let them eat cake: Satisfying the new consumer appetite for responsible brands*. Godalming: World Wildlife Foundation.

We have actually proved very good at squeezing more functional and emotional value out of less material, thanks to our advances in computing, transport, agriculture and so much more. Think of how much value you can get from a palm-sized smart phone, and how much material you would once have needed to use its functions: telephones, records, gramophones, microphones, keyboards, compasses, calculators and countless more goods, all now redundant, and most of them made from oil, scarce minerals, or both. The “de-materialisation” of value in this way must be a key plank of any sustainable economic strategy, especially one that hopes not to be laughed out of the room when it talks of “green growth”.

If all of this sounds too radical or ambitious, bear in mind that the UN and member countries, including the UK, have already begun logging and valuing many forms of natural capital. Business has started thinking about what kinds of currency, systems and business models might allow them to account for and profit from being sustainable. The groundwork is being done, but it is being ignored at the highest levels in the most powerful government departments, most notably HM Treasury.

Taking stock in a networked world

True sustainability is a systemic concept, not something that applies separately to any individual person, company, state or product. It implies that the entire system in question – in this case, the global economy, including its natural resource base, and the UK economy – is operating in a way that can continue indefinitely.

The old, linear model of production and consumption, in which resources were extracted, processed and thrown away – and even the circular model of “closed loop” systems that has struggled to replace it – are no longer fit for purpose. Over the next few decades, we must shift to a more complete model that recognises the full complexity of the flow of materials, energy and information in modern economic systems.

One such model, called the “Value Net”², sees the economy as a network of interactions and value exchanges between many different actors, including millions of businesses, and millions of individuals acting in various capacities and contexts – as consumers, employees, professionals, friends, and so on. The concepts of production and consumption become increasingly blurred as people exchange market-related information and even create their own markets, often with the help of technological intermediaries and social media platforms, such as eBay, Facebook and TripAdvisor. The Value Net retains as much value as possible, for as many people as possible, and for as long as possible, and minimises the loss of value through inefficiency and waste. It recognises that value can be created, shared and destroyed simultaneously in many parts of the system, rather than following a linear or circular path.

In this new economy, there will be new ways for consumers to engage in strategy development, innovation, design, marketing and distribution. This will produce different, more inclusive business models: hotels as brokers and facilitators of peer-to-peer domestic swaps; mesh networks as cheap, secure ways for people to connect with each other; distributed power networks of micro-generators and local hubs, supplementing or replacing energy from large power stations; intensive farming giving way or being substantially supplemented by smaller scale mixed farms, permaculture, gardening clubs and allotments; centrally-coordinated individual transit pods in cities, and more car sharing, car hire, public transport and video telephony. In all these endeavours, economic incentives matter, and business needs law makers to reward the creation and conservation of true value.

Taking stock of true value

For the economy to remain viable, the ecosystems and resources upon which it depends must be maintained. Businesses rely on ecosystems that provide critical provisioning services, such as food, fibre and water, and regulatory services, such as climate regulation, water purification, flood management and waste treatment. Should any of these services be critically degraded, or should vital stocks of natural resources become too scarce, our future success is in jeopardy.

2 WBSCD (2011) *A Vision for Sustainable Consumption: Innovation, Collaboration and the Management of Choice*, Geneva: WBSCD.



On a global scale, we are using up natural resources 52% faster than our planet can replace them³, and stressing some key natural life support systems to breaking point. Three critical ecological boundaries have already been breached: climate change; the nitrogen cycle; and biodiversity.

2010 saw the biggest increase in global greenhouse gas emissions ever recorded – 6 per cent more than the previous year.⁴ According to the latest climate estimates, temperatures could rise by more than 6 degrees centigrade – a catastrophic (and catastrophically expensive) level by any reckoning – by the end of our children's lifetime; a 1 degree rise – far more manageable and less expensive – might be possible, if we act quickly and decisively. The nitrogen cycle is under even greater stress, exceeding natural limits by almost 400 per cent. Biodiversity across the planet has dropped by 30% in the last four decades. According to the UN's Millennium Ecosystem Assessment, 60 per cent of the world's ecosystem services have been degraded over the past 50 years. Of the range of services delivered in the UK by eight broad aquatic and terrestrial habitat types and their constituent biodiversity, about 30% are in decline. With growing levels of per-capita consumption fuelled by global population growth and economic development in developing countries, all of these problems are set to worsen.

At their heart lies the fact that natural resources and ecosystem services are “free”. It generally costs nothing to emit greenhouse gases, despite the huge and growing costs of climate change. Trees are usually worth more dead – for their wood and for the space they clear for intensive agriculture – than alive. Oil itself is free, even though the operational costs associated with its extraction are high and rising. As a result, responsible businesses can end up being forced out of the market by “free riders,” who take advantage of externalities to hog scarce resources or undercut prices.

Whilst several leading businesses have announced extremely ambitious carbon emission reduction targets, they have so far failed to shift to sustainable business models or even to articulate realistic strategies to achieve them; their net impacts on the environment remain negative, and growth causes those impacts to increase.

In order to “de-couple” financial growth from growth in material use and environmental impacts, businesses often need to change both their business models and their cultures. This is difficult and expensive. It is easier and cheaper to concentrate on production efficiencies, which bring quick returns and do not require radical changes to working practices or plant.

So, the economy continues to operate in direct competition with the natural world, even though it depends critically on its natural cycles, ecosystems, products and services. Our politicians are afraid to speak out in support of true sustainability, because they still think in old-fashioned economic terms, according to which Gross Domestic Product (GDP) is the primary measure of national success. True sustainability does not necessarily imply growth in GDP, but in stocks of good things, such as natural capital and human wellbeing.

Addressing market failures

We have not completely ignored the environmental consequences of this market failure. As a society, we have developed retro fixt solutions in the form of environmental regulations, product labelling, certification of raw materials, green taxes, behavioural change campaigns and a host of other interventions, some of which are having some positive effects; but these measures swim against the prevailing economic paradigm, and are not enough to mitigate the negative environmental impacts of human development and economic growth.

The global community and other regional and national governments have also tried to respond, most recently with an agreement at the Rio+20 Conference to develop a set of Sustainable Development Goals, which will build upon the Millennium Development Goals and converge with the post 2015 development agenda. Governments, civil organisations and private companies have worked together to improve the quality and availability of fresh water for agriculture, industry and private homes. Intergovernmental organisations and national governments have published enlightened White Papers and vision documents on sustainable growth and the need to move beyond GDP as a measure of national success.

3 WWF (2012) *Living Planet Report*.

4 US Department of Energy (2011) *Annual Emissions Report*.

And yet, the environmental crisis has not just been given a back seat in UK politics, while we attend to the financial crisis; it has been locked in the boot. Protected areas are now viewed as lost opportunities for economic development, rather than essential resource bases or opportunities for ecotourism. Despite the recent announcements around the development of nuclear power, the future of the UK's energy market after 2020 remains far from clear, particularly for renewables. So does the future of the wider "green business" sector, which, according to the Confederation of British Industry, has the potential to halve our trade deficit by 2014/2015⁵. Despite a clear recommendation from the Committee on Climate Change, the UK government has put off any commitment to a "decarbonisation target" until after the next general election, in May 2015.

To achieve a sustainable economy, two market reforms are urgently required: the effective internalisation of environmental costs and benefits; and a focus on stock levels, rather than flows, as a key indicator of economic success and resilience.

Accountants are already working on ways to allow nations and businesses to measure their performance according to a "triple bottom line" of financial, environmental and social performance. A collaborative project called TEEB (The Economics of Ecosystems and Biodiversity), supported by the United Nations and the G8+5, is working with professional accountancy bodies and public and private stakeholders on ways to value ecosystem services and stocks of natural capital. In November 2012, a daughter project called the TEEB for Business Coalition was launched to achieve a shift in corporate behaviour to preserve and enhance, rather than deplete, our natural capital. To date, the coalition partners, including WWF, UNEP, Defra, the European Commission and The Norwegian Ministry of Foreign Affairs, have commissioned a series of research projects to find out how natural capital accounting can be used to value, manage and report the environmental impacts and benefits of business activities.

Figuring out how this should be done, and then doing it, should be amongst our most important collective projects in the path towards a more responsible economy. This is valuable work that deserves to be better understood and more widely supported by politicians.

5 Commons Select Committees Environmental Audit (2013) *Progress on carbon budgets: Written evidence submitted by WWF UK* s.22.

A Proposal for Self-governing Corporations

Dr. Shann Turnbull, Principal, International Institute for Self-governance

Common sense and fairness require that the license for any large corporate entity to operate should depend upon it paying the cost of its regulation by governments at all levels. An alternative win-win solution is for corporate entities to become self-regulating to avoid government costs while in addition obtaining operating advantages.

The reason that governments introduce laws, regulations, and costly regulatory bureaucracies is to protect citizens from the harms and risks introduced by corporations. However, centralized government red tape cannot efficiently or effectively monitor or reliably regulate the complex diversity of large corporate entities, be they government-owned, non-profit organizations or from the for-profit sector.

One size cannot fit all. This is why socialism does not work. It also explains why top-down corporate regulation proved impotent in avoiding the global financial crisis. Efficient and effective regulation needs to be custom-designed for each corporation. Responsible capitalism requires network governance to provide feedback information from the bottom-up as illustrated in Figure 1 [next page].

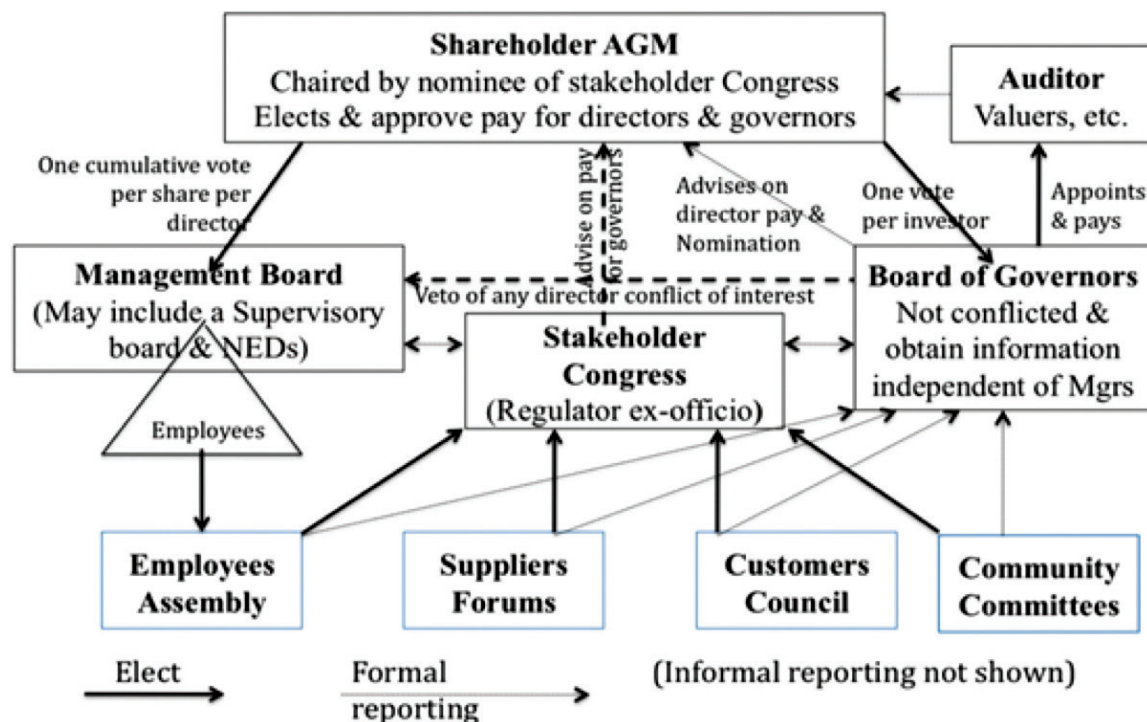
Complexity can only be controlled with complexity. Complex organizations require an appropriately complex control and communication architecture to operate reliably, efficiently and effectively. As no complex organization can exist without stakeholders, it makes sense for complex corporate entities to include their stakeholders in their governance architecture. In this way stakeholders can provide feedback independently of management on the Strengths, Weaknesses, Opportunities and Threats (SWOT) of both the organization and its managers.

Network governance also provides a way of integrating Corporate Social Responsibilities (CSR) into corporate governance. Stakeholders become co-regulators to take responsibility for protecting and furthering their interests without recourse to laws, regulations, regulators, governance codes, legal actions or informal and problematic civic activism.

The need for extensive public reporting of either CSR or governance issues is diminished. This is because any concerned citizen by definition becomes a stakeholder with access to greater information from internal stakeholder communication networks. Much of the existing corporate disclosure requirements make little sense without concerned citizens also having the means to use the information. Network governance provides the means for corrective action to be taken privately by investors, employees, customers, suppliers and those concerned with the environment or other issues.

Figure 1 : Generic illustration of network governance

Separation of governance powers from management allows independent bottom-up and outside-in stakeholder intelligence to integrate governance into CSR management



Many risks, harms and instances of unacceptable behaviour are first identified by stakeholders rather than by the corporation. Network governance provides a way to resolve such issues in real time with local management to minimize the need for external disclosure. If disclosure is still required then the stakeholders involved, rather than the company, could undertake this task to remove the conflicts of interest of corporations reporting adverse news and the need for them to engage expensive and problematic CSR audits.

Network governance also creates a formal framework for operational stakeholders to enhance business operations. This reinforces management practices such as Just In Time (JIT) deliveries, Total Quality Management (TQC) and improving productivity through consumer networks to access innovations. Research has established that 90% of innovations are obtained from consumers rather than expensive internal Research and Development departments.

Stakeholder participation in governance can introduce operating advantages to provide win-win outcomes for the corporation, citizens and governments. It allows citizens to become directly responsible for protecting and furthering their interests independently of local, regional and national governments. Red tape is reduced and responses become more immediate, nuanced and focused, with outcomes directly negotiated between those affected.

Network governance enriches democracy in two ways. First, it introduces stakeholder democracy. Second, this allows stakeholders to become co-regulators to reduce the roles, size and costs of governments at all levels.

If operational stakeholders and citizens in the wider community are to participate in how corporations are governed then greater participation is also required by the shareholders to provide constructive checks and balances. It is by creating internal private competition for corporate control that stakeholder firms like the John Lewis Partnership (JLP) can become both efficient and socially responsible. Stakeholder controlled firms can improve efficiency and competitiveness without the need to become publicly traded if they adopt network governance as adopted by JLP. Listed corporations introduce additional regulatory costs on governments. How stakeholder firms can successfully



combine the apparently contradictory objectives of competitiveness and CSR has been hidden from scholars. As result economists have blindly advocated that government operations become privatized to increase efficiency. Greater economy, efficiency and effectiveness can be achieved in the public or private sectors with network governance. However, university law, business and public policy schools exacerbate the blindness of economists by not teaching the theory or practice of network governance.

A report in 1992 by Harvard professor Michael Porter identified compelling competitive advantages of involving stakeholders in the governance of corporations. Porter recommended that US corporations “nominate significant owners, customers, suppliers, employees, and community representatives to the board of directors”. This would have introduced unmanageable conflicts of interests in corporations with only a single board. Porter overlooked how stakeholder involvement was achieved by indirect ways with separate boards creating network governance in Japan and Germany. As a result his recommendations to US policy advisors and corporations were ignored.

Directors appointed to represent different constituencies are accountable to no one. To create internal private competition for corporate control to improve efficiency with CSR, separate boards are required to represent competing stakeholder interests. This requires amending corporate constitutions to introduce a division of power and checks and balances. Venture capitalists, lenders and Leveraged Buy-out Organisations (LBOs) have perfected ways of introducing a division of powers that do not inhibit corporations from being competitive and adding value.

However, corporate directors generally reject the introduction of a division of power as they lose their ability to maintain their board positions and what they pay themselves. They also lose the power to manipulate how they become accountable to investors and the wider community including the power to appoint and remunerate the auditor who judges their accounts. As none of these powers directly involve how the business is managed, all these powers could be separated into a shareholder-elected “governance” board. This would remove the current systemic unethical conflicts of interest for directors and auditors in UK and US publicly traded firms.

In some European jurisdictions, corporations are required to divide power into three boards to create a simple form of “network governance”. Shareholders elect a supervisory board that determines strategic direction and the appointment of an executive board to carry it out. The shareholders also elect another board to control the auditor. This avoids the conflict of directors selecting and paying those who judge their accounts. Stakeholder-controlled corporations may establish a number of additional boards to represent their various constituencies as indicated in Figure 1. This richer form of network governance is universally found around the world in non-trivial sustainable stakeholder firms.

The existence of network-governed firms in the UK, US and Europe demonstrates that no changes in the law are required, only changes in the corporate constitution that can be undertaken by its members. The incentive for shareholders to introduce network governance is to provide their companies with operating and competitive advantages as indicated above.

There are also additional advantages not considered by Porter, such as reducing the workload of directors by the introduction of distributed decision-making through two or more boards. Network governance simplifies directors’ duties to allow them to become more focused on adding shareholder value. Because systemic unethical conflicts of interest are removed there is no need to appoint Non-Executive Directors (NEDs) and board sub-committees with their associated expenses. Paradoxically the separation of governance and management powers in a single board allows governance and management to be integrated when a network of boards is introduced.

If NEDs are desired then there is no need for them to be classified as independent. It is now members of the board of governors that must be independent of management. The duties of governors are much less onerous as they are not involved in management. This limits their personal liabilities and so the cost of their services. Excessive pay to CEOs is avoided by their directors possessing neither excessive powers nor being dependent upon the CEO for their own pay, perks, prestige, power and influence.

Shareholders are advised by their governors on the nomination and remuneration of their directors and by their operational stakeholders on the nomination and remuneration of their governors. The board of governors would determine the tenure, pay and bonuses of the executives according to how well they improved shareholder value

while protecting and furthering the interest of stakeholders. Executive bonuses would be tied to Key Performance Indicators (KPIs) determined by stakeholders. In this way managers would be motivated to protect and further the interest of stakeholder in a much more expedient, nuanced and responsive manner that could be achieved by government regulators.

The most effective way to make corporations self-governing with network governance is to localize their ownership with local citizens. Democracy and CSR would be further enriched, with citizens obtaining power to protect their local environment. These are just a few of the many benefits that can be achieved by reducing corporate taxes for corporations who obtain agreement from their shareholders to transfer their ownership rights to local citizens over say twenty years.

The most compelling incentive for shareholders to form such “endowment” firms is that all profits would be distributed as dividends each year to provide investors with much bigger cash returns more quickly and so with less risk. Shareholders could maintain their investment in the business by re-investing their dividends in “offspring” endowment corporations established by managers of the progenitor company to maintain and/or grow its business.

Offspring endowment corporations would keep firms to human scale. This would increase the number of firms to improve competition and choice for consumers. Endowment firms would avoid corporations becoming too big to manage, direct, govern or regulate. As citizens can pay tax at a higher rate than corporations, the government could increase its net tax revenues after reducing the tax payable by participating companies.

Both national and local economies would get richer as the export of profits to alien interests would be phased out over time on a basis that would still attract more external investment. Stakeholder shares distributed to all citizens would create a universal minimum income to replace the need for welfare payments, big government and taxes. The role of government would be substantially reduced to provide universal prosperity even without growth to damage the environment.

* Further details and readings on network governance are posted as: “Educating Governance Architects with the science and practices of governance: In the public, private and non-profit sectors” at <https://docs.google.com/document/d/1c9gt9jsSL7i-JovneNfFiGjvxcj2V8Jz98Ku461aHmk/edit>



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