



# Royal Society of Tasmania

Lecture

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UNIVERSITY of  
**TASMANIA** 

It is a particular honour to be giving a lecture in this 175th year of the Royal Society of Tasmania, which so rightly takes pride in being the oldest Scientific society in the Southern Hemisphere and the oldest Royal Society outside of the United Kingdom.

I received slightly challenging advice about this lecture both to bear in mind that the Christmas lecture is usually a light-hearted affair and then the suggestion that I tackle the topic of 'the place of ethics in the modern world', which to my mind is not so light-hearted. As accords with my perhaps overly serious nature, I have taken the ethical steer more strongly and will allow the at times theatre of the absurd that is the heart of what I want to discuss tonight to generate its perhaps own slightly dark form of humour.

We are witnessing the spectacle of the last months of the Banking Royal Commission which has laid bare the gross ethical failings of a range of Australian banks. But it has also revealed a deeper divide between those who were prospering and those who the banks were exploiting and were being left behind.

I am quite sure that Justice Hayne will produce an excoriating report and a sound set of recommendations.

However what I hope is that we might take it as a moment to revisit the unfinished business of the global financial crisis (GFC) and ask some deeper questions about the nature of corporations in our society today and the role they play in contributing to the common good and the current global economy.

I do that as someone who is both an ethicist but also spent a good part of their professional life deep inside that world of corporations. During nearly a decade at McKinsey & Company where I ended up being a partner, I spent time inside a range of Australia's largest companies in multiple sectors and engaged with multi-nationals around the world. I have been a Director of a national commercial law firm and an Enterprise Professor, who co-founded an Institute for Entrepreneurship. This is a world I know very well and perhaps because of that I have a view that it is in deep trouble.

My critique does not come from the modern traditions of left or right but it is grounded in that contemporary version of the pre-modern natural law theory of ethical reasoning which seeks to understand how we reasonably pursue human flourishing as a society.

Equally, as someone very involved in public policy in Australia in the last decade this is also an argument about why informing public policy we need philosophy and history. In that sense, tonight's lecture stands as a powerful defence of the importance of the humanities for shaping policy and responses to banks and the global economy today.

Let me start with the critique. There are plenty of ways of critiquing the global economy and the modern corporation. I see three fundamental problems.

## **First, the promise of progress has been broken and inequality has increased**

From the end of W.W.II. through to 2005 virtually all households in the western world saw their incomes rise. In the decade to 2005, 98% saw their world improve. So since 2005, 65-70% of households have experienced flat or falling incomes. Australia has seen this trend arrive later than most but it is here now.

We know why this happened:

- Slow global growth
- Globalisation that has seen lower skill jobs migrate offshore
- Automation that has reduced the number of entry level jobs in the economy
- Digitalisation that has produced an economy with powerful network effects which means there are returns to scale of ideas and services without a commensurate requirement for a large workforce
- Poorly managed rapid increases in rates of migration which has driven labour rates down in those areas

All but the first of these forces is structural. So while periodic lifts of economic activity will give short-term increases in wages, as is currently occurring in the U.S. thanks to the stimulus from a fiscally unsustainable tax-cut, the gravity of the global economy will keep putting progress at risk for any of those not connected to value-adding parts of the global economy.

The dynamics of this era of globalisation has also accelerated the inherent dynamic of capitalism to wealth inequality that Piketty and others has so well described. It is doing it because the incomes of those connected to the global economy are pulling away from those who are not and they are converting that widening gap into investments, which themselves are growing even faster than income growth.

The moment of hope in all of this is the picture is not uniform and why we need to notice is that it is especially prominent in the culturally dominant economies of the U.S. and the U.K. Other countries notably in northern Europe and to some degree in Australia have done far better. Equally, what the world needs to be clear about is that the U.S. and U.K. do not offer models for the future and should not be looked at as they were in an earlier era.

We know that this failure of progress and rising inequality is driving the deeply destructive politics the world is facing. A politics that actually is set to exacerbate the problem rather than solve it.

The link between the engine of progress stalling and populism is intuitive. But McKinsey put the evidence to the intuition by surveying attitudes amongst those who were and weren't advancing. They explored whether people, irrespective of whether they were advancing or not, were hopeful and then what their views were about topics like free trade and immigration.

At one level the results will not surprise you, but they are sobering. Of those who were not advancing and were not hopeful, 65% agreed or strongly agreed that 'Cheaper foreign labour is creating unfair competition to domestic business'; 56% also agreed that 'The influx of foreign goods and services is leading to domestic job losses'; and, perhaps most toxically, 36% agreed or strongly agreed that 'Legal immigrants are ruining the culture and cohesiveness of our society'.

Importantly, even those who were hopeful but not advancing held very similar views just about 10-15 percentage points less strongly.

By contrast, those who were advancing were far less ready to agree with these propositions.

Others have provided sharp thematic analysis of this problem. I think the Indian writer Pankaj Mishra captures it well in his book *Age of Anger*.

Overlaying the socio-economic groupings who are being left behind is the question of place and geography because disadvantage is not evenly spread. Thomas Friedman in his very famous "The World is Flat" argued for the increasing irrelevance of geography in a globalised world. However, others like Joseph Stiglitz have argued that the power of agglomeration effects actually means place has come to matter greatly with cities being capable of development that sustains competitive advantage to the disadvantage of regional areas. Berkeley economist Enrico Moretti's influential "The New Geography of Jobs" has helped us see the type of cities that would flourish and those are the ones with knowledge and skills intensity.

We have seen that this geographic component matters greatly in the political manifestation of these sorts of inequality. Whether it is who was voting for Brexit or for Donald Trump there is a consistent geography where the strongest supporters are those outside globally-connected, knowledge-intensive metropolitan areas.

In Tasmania, we need to be very conscious of this.

## **Second, the dynamism for renewal of the global economy is being gravely weakened by the very forces that created it**

All the talk of disruption masks the fact that the returns to scale and the power of network effects have seen rapid industry consolidation in sector after sector and the concomitant growth of market power by ever larger corporations.

For those who are not economists it is worth highlighting the central role of network effects in this digital era of the global economy. A network effect describes the increased value for all users when there is an additional user. The internet itself was driven by network effects. The more people connected to it, the more valuable it became to everyone. For any social media site, or on-line market these effects apply. They underpin why Facebook and Amazon are such powerful and highly valued companies. Importantly, once you have captured these effects it makes it much harder for new entrants to attack you so where there are strong network effects monopolies and oligopolies arise.

The use of that market power has seen new business creation in steady decline and it has reduced the power of competition to produce better outcomes from all.

Importantly, the data for this case doesn't come from leftist critics but can now be found in the flag wavers for an open economy and pre-eminently in *The Economist*.

At the core of the problematic dynamic of our current economy is that industries are becoming more concentrated. *The Economist* reports two thirds of America's 900 odd industries have become more concentrated in the last decade (**'The problem with profits' *The Economist*, 26 March 2016**). Indeed, a tenth of the U.S. economy is made up of industries where four firms control 2/3rds of the market (***The next capitalist revolution, The Economist*, 15 Nov 2018**)

We have seen the same phenomena in Australia. Think of banking, telecommunication, and the media, to name just a few. That concentration sees more and more of the Australian economy dominated by oligopolies: not just the sectors I just mentioned but also airlines, supermarkets, and many parts of the construction industry. Oligopolies by their nature seek to extract rent from consumers and suppliers and share it with their owners.

With that consolidation we are seeing all the signs of increased market power.

First, *they are making profits at historically high levels*. In the US return on capital has trended ever higher since the 1990s. (**'Too much of a good thing', *The Economist*, 26 Mar 2016**). In Australia a paper from the Quantitative Finance Research Centre found that in Australia industry consolidations were generating excess returns in the order of 5% between the most and least concentrated sectors.

Second, *a smaller number of players are generating far more of the profits*. In the twenty years from 1994, the US top 100 companies went from generating a third of nominal GDP to nearly a half today. And the world's top 10% of companies generate 80% of the world corporate profits.

Third, *incumbents aren't seeing their profits competed away*. Today a profitable US firm has an 80% chance of staying one. In 1990s that was only 50%

**('Too much of a good thing', The Economist, 26 Mar 2016).**

Fourth, *huge amounts of cash are growing on corporate balance sheets*. Again, in the US that is being added to at about the rate of \$800b a year

**('Too much of a good thing', The Economist, 26 Mar 2016).**

For new business creation, the combination that the market power of the new oligopolists with their huge cash war chests, a network effects-based economy, our current patent regime and government approach to regulation has made is hindering innovation. To any corporate strategists, the logic of what is happening is very clear.

*Oligopolists can buy scale to accelerate their network effects* to make it harder for attackers to pursue them.

*Next they can acquire threats*. Facebook's acquisition of WhatsApp certainly looks like such a move. One can't think Google's purchase of over 180 other technology firms is purely enhancing their existing business **('Nostrums for Rostrums', The Economist, 26 May 2016).**

*They engage in unchecked anti-competitive behaviour*. I have witnessed, through a start-up to which I was close, some very anti-competitive behaviour from incumbent oligopolists. For example, using their volume with a manufacturer to stop a start-up also using those manufacturers; so much so in one case the production had to be shifted to New Zealand. You might say where was the ACCC? The trouble is many of these start-ups aren't in a position to use the ACCC.

*They can horde talent*. Incumbents have put all sorts of clauses in contracts to restrict what employees do when they leave, which has been serious enough that the California legislature has clamped down on it. They are also able to pay extraordinary salaries.

*They can use their muscle to lobby for regulatory changes that make it harder for new entrants*. In the US about \$3 billion a year is being spent lobbying **('The problem with profits' The Economist, 26 March 2016)** and it is growing rapidly in Australia.

*They can use patents in ways that restrict competition*. Large numbers of patents are being registered by incumbents to block off avenues to create competition. They are being purchased to limit rival technologies and, when a number of players want to use them to innovate, they are being charged very high prices to do so.

### **Thirdly, our economy is fundamentally unsustainable**

It is ultimately premised on taking materials from the natural world and transforming them for temporary use and then either disposing of them in ways that they can't be reused or putting them into a recycling process that for almost all materials is putting them into a downcycling process. Even materials like steel, PET plastics and paper lose 30-75% of their value in the first recycle they go through.

This has been a year where that issue has got particular prominence as the global problem of plastic pollution has come to the fore.

To make matters worse we are changing the natural systems of the planet at such a rate that it exceeds the evolutionary adaptive capacity of many species and of ecosystems to unknown consequences.

Anything less than a fully circular economy in which all materials are reused for purposes at least as valuable as the one in the previous cycle of use is ultimately unsustainable.

For this to occur it will require the reinvention of business systems. Happily, some corporations from Steelcase with their chairs to Braun with various of their consumer products are working to create those new systems.

To move to these system is not an anti-economic development argument. In fact, it offers not just an environmentally sustainable path but ultimately one that delivers more value because less is lost. In Europe which is the only place where this thinking is more mainstream, it has been calculated that if Europe moved to a circular economy by 2030 the total annual benefit would be 1.8 trillion euros or 7% higher GDP and, of course, higher without the current massive uncalculated harmful side-effects. Importantly, the analysis of this sort of economy suggests it would also have higher levels of employment and manufacturing because of all that is involved in the recycling process.

However, this requires a great deal of effort by corporations as they reinvent not just their business systems but how whole value-chains work. To harness such a huge level of innovation, companies need to care about it as an intrinsic goal, not just a profit making one. That is why if we are to see corporations do that, we need a fundamental rethink of their nature.

## **The rethink needs to begin with our sense of what Corporations are about and what role they play**

The very corporations that have both created and benefited from the problem need to become central agents to solve it because governments have neither sufficient will nor capability to do it. However, corporations won't be merchants of a better future if they continue to operate on the narrow principle that Milton Friedman so influentially laid out in 1970 when he wrote:

*“There is one and only one social responsibility of business — to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.”*

If corporations are to operate from a broader sense of responsibility, we need to rethink them.

The sense of a need for a rethink has been about for a good while. Well before the GFC brought a sense of moral crisis about capitalism, the corporate social responsibility movement had been trying to call attention to the inadequacies of narrow accounts of corporate obligations. My view is that the movement was well intentioned but lacked solid conceptual foundations, which I think has contributed to the CSR agenda remaining relatively marginal. You always know that the logic of a distinct source of responsibility is not sound when you hear the instrumental argument that taking action on CSR is in the long-run good for profitability because it protects reputation, community licence to operate etc. All of that may be true, but it means both the distinct non-economic responsibilities do not have an intrinsic basis and can always be traded away by a superior claim about profitability.

While the GFC brought a sense of moral crisis about corporations, the closest we got to rethinking the corporation is probably from Michael Porter, at Harvard, in his seminal **Harvard Business Review article (Jan/Feb 2011)** that corporations should create shared value. This was the most substantial progress we made.

I have been arguing for a while, including in gatherings of leading CEOs, that the answer lies in a return to some pre-Enlightenment moral and political philosophy and in moving to an earlier view of the corporation.

Any society that seeks to pursue the common good has to make decisions about how goods and services are to be produced and how are values like freedom and security are to be pursued.



If we start with the production of goods and services, a society needs to decide: what are the goods and services that government will produce? Diverging answers to that question are what animated much of twentieth century history. We sometimes forget just how recently even here in Australia there were government banks, airlines, telecommunications companies – although the politically explosive debates in recent times about privatisation of the energy sector in some states make it clear there is still life in these debates.

Interestingly, and I think importantly given what I will argue, is that Tasmania is fortunate in having a range of its monopoly providers in being State-owned enterprises.

Where that is not true, if government is not the entity that produces these goods and services, then could it be private organisations, profit-making or charitable partnerships, or public companies? There is no right answer to this question. Each mix of choices represents a different political choice about what type of society a country wants to be.

The high-water mark for the role of corporations in delivering the public goods is certainly the United States where, as Micklethwait and Wooldridge write in their wonderfully readable history *The Company*, 'American states used chartered corporations... to build some of the vital infrastructure of the new country – universities, banks, churches, canals, municipalities and roads' (p49). Interestingly, America's oldest corporation is Harvard University.

When societies give corporations the role of delivering the common good, they provide them with very special legal protections. Most particularly, we allow them to have limited liability so that they can fulfil these purposes. With some corporations like banks and airlines, the nature of the goods and services they provide are prescribed by their licences to operate. We put a very strong regulatory regime around them to try to make sure they fulfil the purposes of providing banking services or connectivity within publicly-determined trade-offs about the level of risk we are prepared to accept in participating in these activities.

The important point here is that the purpose of a corporation is not to provide profit but to provide, in the broadest sense, public goods whether it be banking services, connectivity - physical or electronic – energy, or clothes retailers that deliver the choice to express our identity in what we wear rather than to all dress up in Mao suits.

It is important that they truly understand the nature of the public good they are providing. Let me return to the value of the state-owned Tasmanian enterprises and pick just one setting. Aurora provides the option to have your electric heating wired separately so it can go on a different much lower tariff. It seems to me that they have at some level truly understood the public good they provide – it is not energy but warmth in the winter for everyone. No doubt they could make greater profits but they would not be fulfilling their purpose.

Lest there be any doubt, corporations do need to make a profit but I would argue that it is a means to an end, not the end itself. The level of profit required is whatever is sufficient to adequately reward investors so that they will provide the capital the company needs. This does not require extraordinary profits, just ones sufficient to attract the capital required.

When profit becomes the overriding goal, the very purpose of corporations is imperilled. This is surely one of the lessons from the GFC. The quest for profit ultimately put blinkers on an adequate appreciation of risks and actions needed by banks to ensure that they fulfilled the reason for being – which is to provide the banking services that are the foundation of a modern economy. If fulfilling their purpose had been the central concern of those governing them, I think the outcomes could have been very different.

But the public goods that corporations create are not simply the products they make or the services they provide. They contribute a far broader set of goods from employment to the state of the environment. If we are to fix global capitalism, corporations need to change the way they deliver many of these goods.

They need to move away from a model that leaves people behind, which at its core involves a radical investment in the skilling and developing of people whether they are continuing to work in new roles or being helped into new enterprises.

They need to develop business models, like those designed to create a circular economy, to ensure the global commons are improved not depleted.

They need to foster, not acquire, new enterprises and spin out non-core new businesses rather than hold to on them defensively. They need to advocate for the liberalisation, not the tightening, of intellectual property laws. They need to open up their data, not close it.

### **What we can do to reinvent our economy and with it our politics**

If we are clear on what the common good is that we are looking for from our corporations, then not only can we set about supporting them to change their understanding of their obligations but government can be clearer that it has an active role to shape the way they conduct themselves to see those common goods realised.

It is here that we really live between the strategies of left and right and why I would argue that radical return to pre-modern traditions of ethical reflection is important. In making this argument, I am also wanting to make an argument for a return to a different kind of politics.

We have allowed politics in a lot of ways to be turned into a branch of economics through all sorts of utilitarian calculations about what mix of good will produce the greatest happiness, satisfying the most preferences, etc. It is not the place today to make the full argument for why I think this is a failed project, but it has made politics uniquely attentive to self-interested questions of preferences rather than community perceptions of what kind of society they want to live in.

Let me put it by way of example – whether we spend more on sport or literature prizes is a question of national or state identity, not economics. To reduce such an exercise to working out the economic uplift from investments in either choice is to miss the point. These are questions about who we become by what we chose to value.

Political debates are debates about what worthwhile goals we want to pursue as a society and how we want to pursue them. It is the mix of things we choose to pursue by whatever means that contributes to the common good. These are the debates about whether we spend more on sport or more on literature prizes or any other of the important mixes we want to pursue.

If we return to the notion that we created corporations to deliver public goods and an economy where they are as widely available as possible for current and future generations then there are three broad categories of actions we should consider.

### **The first is to support a purpose centred foundation of corporations.**

We could *require all corporations to have a clear statement about the public goods they are delivering in their articles of association* and make it clear in the corporation's law that their first obligation is to deliver those goods.

This is not a new idea. This is just to return to the origins of companies as chartered corporations.

Where there are state owned corporations as we have here, we could lead the way in setting out what the public goods are. Interesting, given the public goods I have observed Aurora delivering that is not what you find in the Articles of Association.

When I looked at Aurora Energy's Articles of Association I found in Clause 5 it sets out its 'Primary Purpose':

- 5.1 (a) The retailing of energy
  - (b) Activities related to or associated with retailing of energy
  - (c) Any other activity, which shareholders may, by special resolution approve.
- 5.2 also says a further purpose is to undertake the retailing of gas

Clause 6 sets out its Principal Objectives

The principal objective of the Company are:

- a) To operate its activities in accordance with sound commercial practice
- b) To maximise its sustainable return to shareholders.

I think there is a real opportunity for the law to catch-up with practice and to set examples that both public and private corporations could follow.

The second is to ensure the institutional framework from the nature of markets to intellectual property is directed to maximising the benefit for the public. There are a number of things we can do.

First, *get much tougher action to create more competitive markets*: raise the bar significantly for mergers; much more rigorous examination of the use of market power in oligopolistic markets; readiness if it is abused to force demergers and sales to reduce market dominance; careful scrutiny of moves up and down the value chain; and very careful examination of attempts to cross-subsidise.

Part of this needs to be increasing investment in the ACCC so they can do more to make it easier for start-ups to bring complaints and not have their businesses effectively consumed by the process of bringing a complaint.

We need to remember that these are not new things for governments to do. Recall the Sherman Anti-Trust Act which was passed almost unanimously by Congress in 1890 and when Theodore Roosevelt came to power he had 45 companies sued, William Taft had another 75 sued and ultimately even the extraordinarily powerful John D. Rockefeller famously saw the Supreme Court uphold the fact that Rockefeller's Standard Oil Company was in violation of the Sherman Act and should be broken up. That history should give spin to governments and regulators alike.

Second, *we need to move more boldly to consider how to reduce the power of network effects*. In the old days of physical networks, we required the opening up of dominant networks like those of telecommunications companies to other players. Terrifying as it might be to today's internet incumbents, their data about consumers which is after all created by consumers, not just companies, could be made available to other players as a network asset. We need to think about these moves. Again, we have done it in an earlier era and we need to do it again.

Third, *on intellectual property rights we need to look at initiatives to re-balance the public/private good trade off.* There should be a 'use it or lose it' rule for patents because 40-90% of patents depending on the study aren't used by their owners. (**'Time to fix patents', The Economist, 8 Aug 2015**). The 'non-obvious' requirement should be made tougher. Apple should not have a patent on rectangular tablets with rounded corners and Twitter shouldn't have a patent on pull to refresh feeds (**'Time to fix patents', The Economist, 8 Aug 2015**). There should be more variable lengths on patents. 20 years as a standard makes no sense in a fast moving economy. (**'Time to fix patents', The Economist, 8 Aug 2015**)

Fourth, *there would be strong prohibition on clauses designed to limit the mobility of talent.*

Fifth, *we need to do more to limit the power of lobbying.* Ever greater transparency is probably the best step.

There is nothing to suggest that the populist's prescriptions will fix the economies that got them elected. It is time to build a new consensus across the boundaries of left and right about what is required to re-design the economy so we can rebuild an inclusive society where all are progressing once again and our political world has become functional again in solving the problems all citizens face every day.

## **Supporting the evolution of the Circular Economy**

The final category of actions we need to take is to support the evolution of the business systems to a proper circular economy. There are some well thought through approaches which have been developed in northern European countries that we can look to.

This is always a challenge because it involves the global production system, and is especially challenging for an island economy like ours that is very dependent on that system for many of its products. However, as an island we have both more pressing needs and at time greater opportunities.

It starts with setting goals and aspirations.

The starting point is energy, and here Tasmania has a huge advantage because we can be energy independent with renewables.

It is then about waste management.

Our needs when it comes to waste management are high because if material can't be recycled they rapidly end up in landfill or our environment and even if they are in landfill they can readily leach their chemicals into our waters.

We need to evolve a strategy that progressively raises the bar so the only materials that come to the island are part of a closed loop that sees them recycled here or as part of a national or international scheme. To push the creation of such a business model, we could create an obligation on major retailers to take their packaging and their products back at the end of their life. If that sounds implausible, recall that already today some supermarkets on the island are taking back recycled plastics that are otherwise hard to recycle.

Next, we should make sure our laws support asset-sharing and lifetime loan business models which can underpin models of products being returned to their owners.

While it is not a matter a small state can effect, there is an opportunity to require labelling about lifespans of products and percentage of components of recycled and recyclable materials in them. We have got used to looking at the operational efficiency of products with their star rating. In time we could do that for their life-time sustainability.

In smaller economies, we can also develop sector strategies for those sectors which are local enough that we can shape them. There is work in Europe on agriculture aimed at dramatically reducing waste in the whole production cycle.

Perhaps more significantly for the Island, circular buildings have a real potential especially if we focus on construction in timber. It is about making buildings with techniques that enable you to take them apart at the end of their life and reuse their materials. It is possible to use planning laws to drive in this direction. Certainly, we should be resisting the use of toxic non-recyclable materials like polystyrene that are increasingly used to create highly insulated buildings which, while they save energy which is good, are actually part of a totally unsustainable production system.

## **Conclusion**

I see the role of universities and their people is to introduce ideas as I have tonight that might seem a little less than mainstream and to create the space for them to be explored. If there is some sense to them they can come in time to form a new consensus that becomes the basis for reform. There was once a time in Australia when the notion of an internationally open economy and the privatisation of corporations was unthinkable until it wasn't.

What I have argued for in this lecture has advocates in the mainstream so there are coalitions of support building around these ideas and most have historical precedents so we know societies can and do pursue them.