Henry Jackson
INITIATIVE

TOWARDS A MORE INCLUSIVE CAPITALISM

BY THE HENRY JACKSON INITIATIVE
FOR INCLUSIVE CAPITALISM

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CONTENTS

EXECUTIVE SUMMARY

- At a time when capitalism is very much under siege, this paper makes the case that it remains the most powerful economic system we have for raising people out of poverty and building cohesive societies.
- At the same time, we, the members of the Henry Jackson Initiative for Inclusive Capitalism task force—a trans-Atlantic and non-partisan private-sector group of business, policy and academic practitioners—recognize that the recent crisis has highlighted a number of weaknesses in the system.
- Accordingly, we set out the case for capitalism, identify three areas in which progress needs to be made to improve it, and identify a number of companies already working in these areas to improve the functioning of our system. The Initiative will continue to highlight and encourage businesses and other organizations working in these areas, and to promote the broadest possible adoption of best practices. We close the paper with a discussion of the absolute necessity of improving basic standards of ethical behavior in business.

THE CASE FOR CAPITALISM

- Despite what the current gloom might suggest, capitalism has made the world healthier, richer and freer than previous generations could have imagined. People in capitalist societies live longer than their forebears, earn more and are better educated.
- At the same time, we recognize the serious dislocations caused by developments in the capitalism of the last 30 years—developments exacerbated by the recent crisis:
  - Several million manufacturing jobs have moved to developing countries where labor is cheaper. Many who lost their jobs in the developed world are not qualified for the alternative jobs that are emerging. Youth unemployment is unacceptably high.
  - Income inequality has radically increased over the last 30 years in the U.S. and the U.K.
  - Market pressure and compensation structures led managements to focus more sharply on short-term profits than on the long-term requirements of their businesses.

THREE PATHWAYS

We believe the ideal response is for companies to ensure that everyone—all stakeholders, not just shareholders—derive benefits from business. **The three crucial areas we have identified in which companies and institutions can make, and are making, positive progress are (a) education for employment, (b) support for small and medium-sized enterprises (SMEs), and (c) improvements in corporate management and governance for the long term.**

EDUCATION FOR EMPLOYMENT.

In the U.S., the current mismatch between today's educational model and the needs of today's job market has contributed to an unemployment rate of 24.9 percent among those aged 16-24. In the U.K., over one in five young people is unemployed. **We found several ways in which businesses, and sometimes successful business people, are addressing the education gap, including programs to get people into the workforce, apprenticeships, internships and education programs designed to lead to fulltime jobs.**

NURTURING START-UPS AND SMES.

SMEs are the backbone of the U.S. and U.K. economies, representing over 99 percent of all businesses and approximately half of employment in both countries. In the US, 62 percent of net new jobs from 1992 to 2010 were created by SMEs. Recently, however, the success rate of small businesses has dropped. **We believe large companies can help SMEs without making any significant compromises to their own profitability. For this to happen, however, they must mentor SMEs in working more successfully as suppliers to large companies. SMEs also need better access to credit.**

REFORMING MANAGEMENT AND GOVERNANCE FOR THE LONG TERM.

As many business leaders have noted, corporate governance failed dramatically in a number of cases in the recent crisis. Executives managed their companies to a short-term notion of shareholder value rather than to the businesses' long-term health, and boards of directors did not remedy the problem. **Today's focus on short-term performance must be replaced by long-term thinking on everybody's part. Companies need not offer quarterly earnings guidance. They should seek ways to reward investors who hold their shares for the long term. Large investors should create portfolios of larger shares of fewer companies so that they can be more active owners of those companies. Directors must spend more time on strategy.**

Ethics

"Improving the ethics of the business world is fundamental to solving capitalism's current problems. We believe the recommendations regarding investing for the long term and corporate governance will help. We are encouraged that the market itself is beginning to rectify the situation: some companies and shareholders are taking serious steps against excessive CEO compensation, for instance. But the heart of the remedy must be a near-revolution in personal ethics, for the regrettable behavior in the recent crisis was mostly unethical rather than illegal. Only if people become more aware of the moral dimension of their personalities, and bring them into their business decisions, will we avoid a repetition of the problems we have suffered."

CONCLUSION

We are interested in maximizing the extent to which capitalism can heal its own ills. This is not an argument for an unregulated society, but we leave the details of regulation and taxation to others. The Henry Jackson Initiative for Inclusive Capitalism will work in the U.K. and the U.S. to promote a debate about the benefits of capitalism and how to share those benefits with as many people as possible. It will also act as a clearing house to identify and disseminate knowledge as widely as possible about promising programs in the three areas outlined. For the essence of our argument is that business needs to take the lead in the areas that need improvement most. These businesses understand it is in their best interest to improve the overall environment for business and the economy. As long as industry, innovation and enterprise are anchored by inclusivity and responsibility, the capitalist system that has made our societies great will continue to do so.

INTRODUCTION

CAPITALISM, FOR ALL ITS FAULTS, REMAINS THE MOST POWERFUL ECONOMIC SYSTEM FOR RAISING PEOPLE OUT OF POVERTY AND FOR BUILDING SUCCESSFUL SOCIETIES. IT IS IMPORTANT TO HIGHLIGHT THIS ENDURING REALITY AS PUBLIC ANGER CONTINUES TO RISE IN MANY COUNTRIES OVER EXCESSES AND ABUSES THAT HELPED CAUSE THE FINANCIAL TURMOIL THE WORLD HAS EXPERIENCED SINCE 2008. THIS ANGER IS FUELED BY THE SENSE THAT THOSE ON THE "INSIDE" HAVE BEEN DOING WELL WHILE PEOPLE ON THE "OUTSIDE" HAVE BEEN STRUGGLING WITH LITTLE SECURITY OR UPWARD MOBILITY. THE PRIMARY OBJECTIVE OF THIS REPORT IS TO HIGHLIGHT AND PROMOTE THE WORK THAT BUSINESSES NEED TO DO, AND IN MANY CASES ARE DOING, TO ENSURE THAT WESTERN-STYLE CAPITALISM FUNCTIONS IN AN INCLUSIVE MANNER FOR ALL, AND IS NOT UNDERMINED EITHER BY A FAILURE TO REFORM WHERE REFORM IS NEEDED, OR BY THE ACTIONS OF A MINORITY OF INDIVIDUALS AND INSTITUTIONS WHO STEP INTO MURKY ETHICAL TERRITORY IN THE PURSUIT OF GAIN.

In an interview quoted by *The Economist* in 2012, Andrew Grove, ex-CEO of Intel, noted that because his generation witnessed "the decisive victory of free-market principles over planned economies" there has been a stubborn tendency to stick with the belief that "the free market is the best of all economic systems—the freer, the better…largely oblivious to emerging evidence that while free markets beat planned economies, there may be room for a modification that is even better."[1]

We believe that there *is* a "modification that is even better". To make our form of capitalism more inclusive, some of its elements must be improved. We do not believe it is enough to claim the virtues of Schumpeter's "creative destruction", while ignoring that the jobs created cannot usually be performed by those whose jobs were destroyed. We acknowledge that smaller businesses need help if capitalism's crucial engine—companies with a few hundred employees or less—is to fire on all cylinders once again. We recognize that the British and American company governance model did far too little to prevent the economic train-wreck that has caused so much anguish since 2008. Finally, to speak bluntly, we believe that a broad-based acceptance of basic ethical norms is necessary if any form of capitalism is to be widely accepted. Otherwise, the system itself will be discredited and ultimately destroyed, whether by internal failures, external pressures or both—or by some other unforeseen and undesirable force.

Accordingly, the focus of our task force is on what the private sector can do, and, in many cases is doing, to make our capitalism more inclusive. We leave the details of regulation and tax regimes to others. We decidedly take no position as to exactly what level of taxation and regulation best balances the ability of government to do what it must without harming the desire of entrepreneurs and businesses to do what they can. We leave specific issues of compensation to the companies that must balance the interests of their management, shareholders and society. We believe the most effective activities in which the private sector can engage are, first, improving "education for employment"; second, doing a better job of supporting small- and medium-sized businesses; and third, making sure companies are managed and governed for the long term—all in a context of working to encourage the adoption of basic ethical norms in all businesses for the overall health of capitalism.

1 'And the Winner Is… For All Its Successes, State Capitalism Has Fatal Flaws', *The Economist*, January 21, 2012.

Why these three pathways? These are, we believe, the most important areas businesses can address through clearly defined, concrete programs that will create provable impact. No doubt there are many other things than can be done by businesses, individuals and institutions, but we believe that a broad-based focus on these areas by the private sector will significantly advance us toward more sustainable capitalism. No society can thrive if its citizens are not qualified for the jobs it creates; if its small businessmen and businesswomen cannot keep their heads above water; if large companies are not managed for the long term and guided by independent boards of directors; and if business as a whole is not driven by a spirit of conscience.

No society can thrive if its citizens are not qualified for the jobs it creates; if its small businessmen and businesswomen cannot keep their heads above water; if large companies are not managed for the long term and guided by independent boards of directors; and if business as a whole is not driven by a spirit of conscience.

In this paper, we share the Henry Jackson Initiative for Inclusive Capitalism's views about the way forward. But we seek to do more. We believe there is value in *identifying* and *supporting* efforts already under way in these areas. We wish to draw attention to successful efforts already being undertaken by firms and individuals in the United States, the United Kingdom, and in continental Europe—efforts that are helping hundreds of thousands of people and making our capitalism more responsive to the needs of all. We understand and applaud that these efforts are being taken in the best business interest of the institutions involved because, as Adam Smith believed, it is through the pursuit of enlightened self-interest that we benefit all of society.

We begin with the case for capitalism in spite of the many burdens we are struggling with now, and go on to discuss the three areas for action we have identified, as well as the overarching need for ethical behavior. In each case, we highlight a number of active efforts by companies, groups of companies, or other organizations to further the goal in question. As the Initiative develops, our group will work with the companies running these programs and highlight these and other programs through our website, www.henryjacksoninitiative.org. Our ultimate aim is to encourage the widest possible adoption of business-driven programs that support the goals we have identified, and to make them known to other companies and the general public.

ADAM SMITH AND THE CASE FOR INCLUSIVE CAPITALISM

The case for capitalism over the long term is very strong. To say so is not to diminish the suffering caused by the recent economic crisis. It is to insist that, for everyone's good, capitalism should be defended against those who claim its flaws are fatal—but that those flaws should be fixed.

Adam Smith, often regarded as the "father of capitalism", believed that the collusion of government with the powerful business interests controlling the markets of his day was unethical and unproductive. He conceived of capitalism as an economic system that opposed the mercantilism of the time, a system that favored consumers rather than producers, and one that would yield wealth as broadly as possible while encouraging discipline, moderation and order throughout society. His was a very democratic, even populist, notion of the purpose of the market.

Crucially, Smith's confidence in capitalism came from his work—even his obsession—as a moral philosopher. He believed that people, who were fundamentally self-interested, could be guided toward sympathy and benevolence in a well-functioning society because of their desire for the approval of their peers. In *The Theory of Moral Sentiments,* which preceded *The Wealth of Nations* by 17 years, he wrote that "the great secret of education is to direct vanity to proper objects." By so educating them, people would be led to pursue a comfortable life within the rule of law. That he considered this goal within the reach of most members of society is evinced by his observation that the wealth of a state "consists in the cheapness of provision and all other necessaries and conveniences of life".

Capitalism has made the world richer and freer than previous generations (and probably even Adam Smith) could ever have imagined.

History has borne out his fundamental insight. Capitalism has made the world richer and freer than previous generations (and probably even Adam Smith) could ever have imagined. The lives of people around the world are getting better. In 1981, 1.93 billion people lived on under $1.25/day, the World Bank's indicator for extreme poverty. By 2008, that number had dropped by over a third to 1.28 billion.[2] Not even the 2007/2008 global recession—the worst since the Great Depression—slowed down the rate of poverty reduction. The United Nations estimates it will have achieved its Millennium Development Goal of halving extreme poverty from 1990 levels well before 2015.[3]

People in capitalist societies live longer than earlier generations, earn more and are better educated.[4] Each year, the United Nations publishes an index of human development that measures the progress of countries with respect to health, education, income, and other social and economic factors. Between 1970 and 2010, the average overall global score of the index increased by 41 percent, while the world's poorest countries enjoyed an average increase of 61 percent.[5]

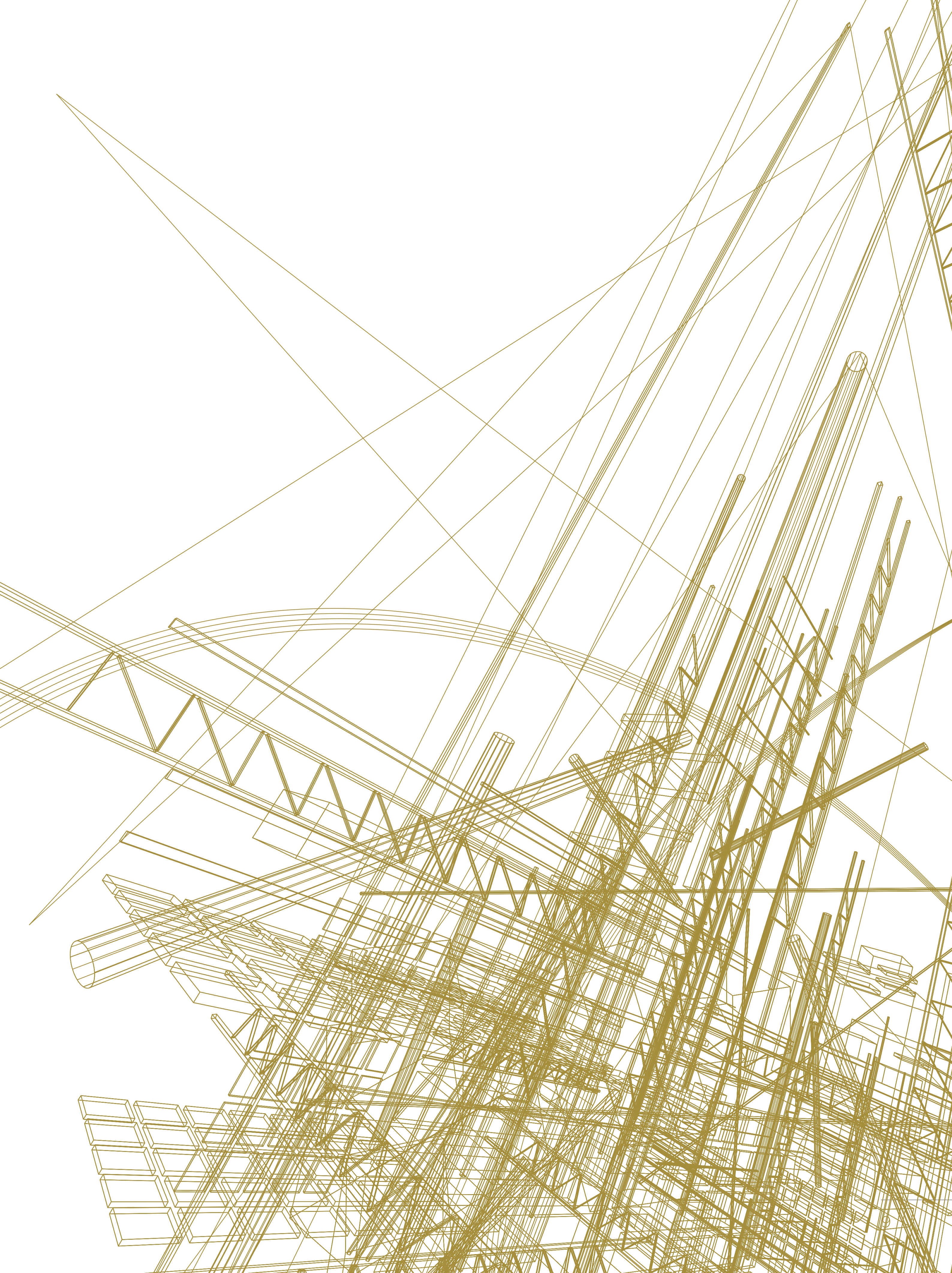
This dramatic improvement is the result of economic growth all over the world, particularly

2 The World Bank, 'Regional Aggregation Using 2005 PPP and $1.25/Day Poverty Line', PovcalNet, http://iresearch.worldbank.org/PovcalNet/index.htm?1 (accessed May 6, 2012). 1981 and 2008 numbers both in 2005 dollars.

3 The World Bank, 'World Bank Sees Progress Against Extreme Poverty, But Flags Vulnerabilities', PovcalNet, http://siteresources.worldbank.org/INTPOVCALNET/Resources/Global_Poverty_Update_2012_02-29-12.pdf (accessed May 6, 2012).

4 Societies in transition typically make an exception to this rule. For instance, life expectancy in the USSR was about 70 in 1986, prior to disruptions in the healthcare system with the collapse of the Soviet system. Life expectancy fell for some time after the transition, and was still at about 66 in 2006. Today, however, it is back up to 70.3, suggesting that even a capitalist society suffering high levels of inequality is as healthy as the Communist alternatives. The current five-year trend suggests that life expectancy will continue to rise.

5 *The Real Wealth of Nations; Pathways to Human Development, Human Development Report 2010*, UNDP, http://hdr.undp.org/en/reports/global/hdr2010/ (accessed May 7, 2012).



among developing nations. The opening of markets has enabled entrepreneurs everywhere to risk capital, invest in new businesses, trade with foreign companies and satisfy consumers. In turn, jobs have been created and lives improved.

Indeed, although this paper mostly concerns itself with British and American capitalism, the embrace of capitalism to some degree in very many places around the world has clearly improved lives. The general rejection of full-scale socialism in the BRIC countries, and in many countries in South America and Africa, has raised the living standards of over one billion people. China has been transformed by Deng Xiaoping's assimilation in the 1970s of a number of capitalist principles into the "socialist market economy". In India, capitalist reforms that included the end of the "license raj" and import controls have propelled average economic growth of 7.6 percent per year for the last decade.[6] In Vietnam, only 16 percent of the population lives in poverty today, as opposed to 63 percent in 1993.[7] Developing nations have opened up to foreign investment and created millions of new jobs in export-oriented industries.

But the virtues of capitalism cannot be trumpeted without recognizing that these very advances have created serious challenges in the developed world. Several million manufacturing jobs have moved to developing countries where labor is cheaper. The employees who lost those jobs are not trained for the higher-skilled jobs that are emerging in their place. The developed-world employment problem is particularly acute for the young: the number of entry-level jobs that secondary school graduates depended on to start their careers has dropped. Levels of youth unemployment in the U.K. and U.S. are much higher than the broader national average in each case.

A world in which executives send jobs offshore and concentrate on decisions that will move the company's share price in the short term is not a world in which public trust in business will be robust.

Another destabilizing aspect of contemporary capitalism is that the pressures of today's short-term-focused market (as well as the compensation schemes of many public companies) lead management to focus more sharply on short-term profits than on the long-term requirements of their businesses. Many CEOs and boards manage companies to quarterly earnings targets in order to generate the highest returns *now*, with too little focus on the long-term needs of the company. This remains the case in many companies, despite the crisis of 2008.

A world in which executives send jobs offshore and concentrate on decisions that will move the company's share price in the short term is not a world in which public trust in business will be robust. In a recent speech, Richard Edelman, President and CEO of Edelman Worldwide, noted that, according to the Edelman Trust Barometer, trust in business in the U.S. fell from above 50 percent in 2007 to the mid-30s in 2009.[8]

Perhaps the thorniest problem with British and American capitalism is the income inequality that has developed over the last 30 years. This issue is often advanced as Exhibit A in the case against capitalism. The facts are stark in both the U.S. and the U.K. In the U.S., between 1979 and 2007, according to an analysis from the Congressional Budget Office, the real after-tax household income of the top one percent grew 275 percent, and that of the next 19 percent grew

6 The World Bank, World Bank Development Indicators, http://databank.worldbank.org/ddp/home.do (accessed May 6, 2012).

7 Ibid.

8 Richard Edelman, 'Earning the License to Lead' (speech, Marquette University's Diederich School of Communication, Milwaukee, WI, April 20, 2012).

65 percent. The 60 percent in the middle grew just under 40 percent. The after-tax income of the lowest 20 percent grew only 18 percent over this period. In the period 2005-2007, leading up to the financial crisis, the top 20 percent of U.S. income earners made more than the entire 80 percent of wage-earners below them.[9] In 2007 alone, the top 10 percent earned 49.7 percent of total U.S. income, the greatest earning disparity since the 1930s.[10]

The details are even more disturbing. In 2007, 23.5 percent of all American income flowed to the top one percent of earners. Staggeringly, the top 0.1 percent earned 12.2 percent of all income in the United States in 2007, up from an average of 3.5 percent in the 1960s.[11] Sadly, the trend worsened after the Great Recession. From 2009 to 2010, the top one percent of incomes grew by 11.6 percent while the bottom 99 percent grew by only 0.2 percent, meaning that in the first year of the recovery 93 percent of income gains were captured by the top one percent of income earners.[12]

Capitalism was not always like this. From 1943 to 1983, wealth was much more evenly spread. Between 1970 and 1979, CEOs earned approximately 40 times more than the average American worker. Today the average CEO earns 380 times more.[13] The 1950s through the 1980s was the golden age of the American Dream: we all believed that America was a level playing field and if we worked hard and played by the rules, there was no limit to the success we could enjoy in a country of endless possibilities.

The Harvard economist Larry Katz offers this analogy: "Think of the American economy as a large apartment block…. A century ago—even 30 years ago—it was the object of envy. But in the last generation its character has changed. The penthouses at the top keep getting larger and larger. The apartments in the middle are feeling more and more squeezed and the basement has flooded. To round it off, the elevator is no longer working. That broken elevator is what gets people down the most."[14] The famous comedian, George Carlin, articulated what a lot of middle class Americans are probably thinking these days: "It is called the American Dream because you have to be asleep to believe it."

Similarly, income inequality has been growing sharply in the U.K. in recent decades, where growth has largely been captured by the wealthiest in society. In 1981, the top one percent of earners accounted for 6.6 percent of total income in the U.K. By 2009, their share of total income more than doubled, to 13.8 percent. And the U.K's super wealthy, the top 0.1 percent, saw their income share rise from 1.5 percent of the total to 5.1 percent. At the same time, the U.K.'s middle class has largely stagnated or declined.[15] Defined as the households between the 10th and 50th percentiles of income, this group's share of British income has dropped from 30 percent in 1977 to 22 percent in 2009.[16]

What is the answer? We are cautious about regulatory solutions because the recent crisis occurred in the context of a rules-based system: most of what went wrong did not involve illegal activity. Accordingly, we believe companies and individuals must work to make our

9 *Trends in the Distribution of Household Income Between 1979 and 2007*, Congress of the United States Congressional Budget Office, October 25, 2011, pg. ix http://cbo.gov/sites/default/files/cbofiles/attachments/10-25-HouseholdIncome.pdf (accessed May 6, 2012).

10 Emmanuel Saez, 'Summary for the Broader Public, Striking It Richer: The Evolution of Top Incomes in the United States', http://elsa.berkeley.edu/~saez/ (accessed May 6, 2012).

11 Ibid, table A3.

12 Ibid, 4.

13 Carola Frydman and Raven E. Saks, 'Historical Trends in Executive Compensation, 1936-2003', (paper presented at University of Chicago, Chicago, IL January 18, 2007), 45 http://www.vanderbilt.edu/econ/sempapers/Frydman1.pdf (accessed May 6, 2012); and AFL-CIO Calculations, 2012.

14 Edward Luce, 'The Crisis of Middle-Class America', *Financial Times*, July 30, 2010.

15 Facundo Alvaredo, A.B. Atkinson, T. Piketty, and E. Saez, The World Top Incomes Database, http://g-mond.parisschoolofeconomics.eu/topincomes/ (accessed May 6, 2012).

16 James Plunkett, 'Growth Without Gain?: The Faltering Living Standards of People on Low-to-Middle Incomes', Resolution Foundation May 27, 2011 http://www.resolutionfoundation.org/publications/growth-without-gain-faltering-living-standards-peo/ (accessed May 6, 2012).

capitalist system more inclusive and therefore more sustainable. If companies, particularly large companies, are to regain the trust they have lost, they must adopt business practices that ensure that everyone—stakeholders, not just shareholders—derive benefits from business. "We once thought," writes Harvard's Michael Porter, "that if business just increases its profit, what's good for business is then good for society.... We need to think differently: what's good for society is good for business."[17]

This idea, expressed sometimes as "stakeholder capitalism" or as the "triple bottom-line", (which explicitly measures businesses by their social and ecological performance as well as their profitability) is not new. Indeed, more than a hundred years before either of these terms entered the business lexicon, William Lever, the creator of what is now Unilever, built a garden village to house his workers. Lever introduced an eight-hour work day, health benefits, vacation pay and pensions. As Niall Fitzgerald, Unilever's chairman from 1996 to 2004, said, "Business is part of society, not outside it."[18]

A more modern example of business acting in the best interest of society as well as its own is now taking place in Minnesota. Leaders of the state's major businesses, along with the state's civic leaders and foundation heads, have created a program called the Itasca Project, established to improve regional economic competitiveness. The initiative, which includes more than 50 business leaders, including the CEOs of Cargill and General Mills, works on issues that help to improve both business and society, such as generating quality job growth and raising standards of education.

While the problems of capitalism are undeniable, its benefits and possibilities are even greater. Capitalism has not created a utopia, but it does give the most people the best opportunity for a better life. It is in this context that we move now to the three pathways that the Henry Jackson Initiative for Inclusive Capitalism believes can create, and are creating, a more sustainable, inclusive and dynamic capitalism: fostering education for employment, nurturing start-ups and SMEs and reforming management and governance practices to counter short-termism—all in the context of encouraging basic ethical norms in business life.

If there is a single idea that knits these pathways together, and that underlies our notion of an inclusive capitalism, it is the idea of managing companies for the long-term. Companies that manage for the long term worry about the preparedness of their recruits, build long-term and loyal supplier bases, find ways to counter the short-term pressures of the market and behave in ways that will foster long-lasting relationships with all their stakeholders.

"We once thought," writes Harvard's Michael Porter, "that if business just increases its profit, what's good for business is then good for society.... We need to think differently: what's good for society is good for business."

17 Michael Porter, interviewed by Adi Ignatius, 'Rethinking Capitalism', *Harvard Business Review* January 5, 2011, http://blogs.hbr.org/video/2011/01/rethinking-capitalism.html (accessed on May 7, 2012).

18 Niall Fitzgerald, (speech, London Business School, October 13, 2003). You can read an article, 'CSR: Rebuilding Trust in Business' based on the speech at http://www.unilever.com/Images/A%20Perspective%20on%20Corporate%20Social%20Responsibility%20in%20the%2021st%20Century_tcm13-5520.pdf (accessed May 6, 2012).

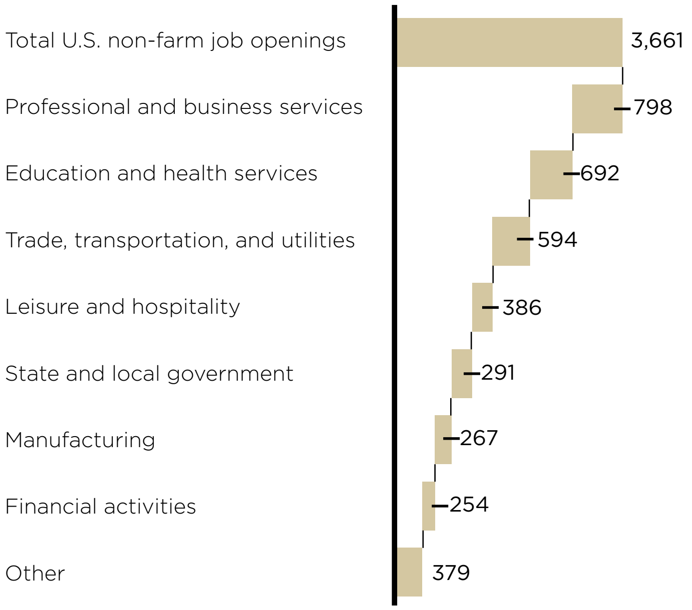
PATHWAY 1: FOSTERING EDUCATION FOR EMPLOYMENT

One of the major problems we face today is that, in Britain and America, many jobs that required only a secondary school education have moved offshore. The ones that are replacing them demand an increasingly sophisticated education. This structural change helps explain an oddity: In the U.S., there are nearly 3.6 million unfilled jobs at a time when 12.5 million workers are unemployed.[19] Put another way, a "right-skilled" workforce would bring the unemployment rate down by 28.8 percent *without any improvement in the economy* (Exhibit 1).

EXHIBIT 1

IN THE U.S., NEARLY THREE MILLION JOBS ARE UNFILLED

U.S. JOB OPENINGS AS OF JANUARY 2012
Thousands (not seasonally adjusted)



SOURCE: US BUREAU OF LABOR STATISTICS, JOB OPENINGS AND LABOR SURVEY (JANUARY 2012, NOT SEASONALLY ADJUSTED), STATISTICS DATA

Many capitalists celebrate the ability of the system to change rapidly in response to market conditions through the process of "creative destruction". They focus on the creativity more than the destruction.[20] But Joseph Schumpeter, from whom they take the term, was himself very much aware of the negative as well as the positive effects of dynamic capitalism. Discussing the rise of the railways, he wrote, "The Illinois Central not only meant very good

19 U.S. Bureau of Labor Statistics, Job Openings and Labor Turnover Survey (January 2011, not seasonally adjusted), Statistics Data, http://www.bls..gov/jlt/ (accessed on May 7, 2012).

20 Most commentators are unaware that Schumpeter took the term from Marxist economic theory, which did not regard it in a positive light. Given this lack of awareness among devotees of Schumpeter—and, to be fair, the fact that the process appears to be positive in its net effects—it is not surprising that modern use of the term tends to focus on the creativity rather than the destruction.

business whilst it was built and whilst new cities were built around it and land was cultivated, but it spelled the death sentence for the [old] agriculture of the West."[21]

The rise of a global labor market and technological advances have accelerated both sides of the "creative destruction" equation, bringing about sweeping changes to the structure of the employment market around the world. Jobs have been lost in the developed world and created in the developing world. In a growing economy, such as that of the U.S in the 1990s with the growth of technology and the Internet, there can be overall job growth despite the destruction of obsolete jobs. From 1994-2001, just under 20 million net new jobs were created, even though 12 million were lost.[22] But in the subsequent years of slow growth, there has been a sharp increase in unemployment in some industries in many countries. The United States and Germany, for example, lost more than a fifth of their manufacturing jobs between 1991 and 2007, according to the United Nations Industrial Development Organization; Japan lost a third.[23]

It may be good news that during the same period, China created over 121 million new jobs for its workers, or that Brazil created nearly 30 million new jobs for its citizens between 1990 and 2007.[24]

But what of the developed world, where these kinds of jobs were previously domiciled?

"The Illinois Central not only meant very good business whilst it was built and whilst new cities were built around it and land was cultivated, but it spelled the death sentence for the [old] agriculture of the West."

Because many Western producers cannot compete on cost, companies in the developed world have been forced to move "up the value chain", creating more productive manufacturing operations that require more sophistication of the people who run them. The problem is that the people who lost their manufacturing jobs in the West are not universally equipped to perform the jobs that have replaced them. A recent McKinsey report noted that only about 15 percent of jobs at the turn of the 21st century related to such functions as running heavy machinery and working on a production line. Some 70 percent of new jobs created since 1998 require deep industry knowledge, as well as judgment and experience.[25] In a 2011 Manpower employment survey, 52 percent of U.S. employers said they were having significant difficulty in filling open positions due to a skills shortage (Exhibit 2).[26]

At the heart of the problem is a mismatch between today's educational model and the needs of today's job market, a problem exacerbated by recent trends in education. In many countries, the focus of government, school and parental interest has been on obtaining a university education for all. Vocational education, meanwhile, has been de-emphasized, except in rare

21 Joseph Schumpeter and Richard Swedberg, *The Economics and Sociology of Capitalism*, (Princeton: Princeton University Press, 1991), 349. Schumpeter's point is that progress in capitalism brings new products and ways of doing business, destroying the older ways in the process.

22 U.S. Bureau of Labor Statistics, Employment, Hours, and Earnings from the Current Employment Statistics survey (National), Total Nonfarm, Seasonally Adjusted (accessed May 7, 2012) and Labor Force Statistics from the Current Population Survey, Unemployment Level—Permanent Job Losers, http://www.bls.gov/jlt/ (accessed May 7, 2012).

23 Eduardo Porter, 'The Promise of Today's Factory Jobs', *New York Times,* April 3, 2012.

24 International Labor Organization, LABORSTA Internet Databse, http://laborsta.ilo.org/STP/guest (accessed May 7, 2012).

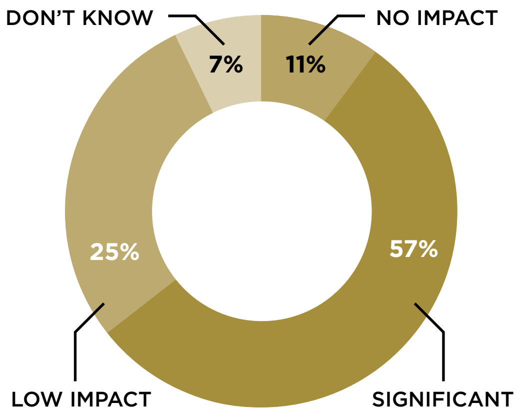
25 Bradford Johnson, James M. Manyika, and Lareina A. Yee, 'The Next Revolution in Interactions', *The McKinsey Quarterly,* November. 2005, 65-7, https://www.mckinseyquarterly.com/The_next_revolution_in_interactions_1690 (accessed May 7, 2012).

26 'ManpowerGroup Annual Survey Shows More Than Half of U.S. Employers Cannot Find the Right Talent for Open Positions', *ManpowerGroup,* May 19, 2011 http://press.manpower.com/press/2011/manpowergroup-annual-survey-shows-more-than-half-of-u-s-employers-cannot-find-the-right-talent-for-open-positions/ (accessed May 7, 2012).

EXHIBIT 2

DESPITE HIGH LEVELS OF UNEMPLOYMENT, EMPLOYERS REPORT SIGNIFICANT DIFFICULTY FILLING VARIOUS TYPES OF POSITIONS

EMPLOYERS REPORTING SIGNIFICANT IMPACTS FROM DIFFICULTY IN FILLING POSITIONS



MOST DIFFICULT POSITIONS TO FILL, 2011

1. **Technicians**
2. Sales representatives
3. Skilled trades workers
4. **Engineers**
5. Laborers
6. Management/executives
7. Accounting and Finance Staff
8. IT Staff
9. Production Operators
10. **Office support staff**

SOURCE: '2011 TALENT SHORTAGE SURVEY," MANPOWER GROUP

places such as Germany, which has a comprehensive apprentice system (and, today, a much healthier economy than most other developed countries). As a result, in the U.S, where the official overall unemployment rate is 8.1 percent, the jobless rate for those aged 16-24 is 24.9 percent.[27] In the U.K., over one in five young people is unemployed.[28]

We found a multiplicity of ways that businesses, and even individuals partnering with non-profits, have been working to increase the number of young people in the workforce. Some efforts are of long-standing nature, some are new. The importance of these efforts cannot be overstated. As the British Prime Minister David Cameron noted earlier this year, "Capitalism will never be genuinely popular unless there are genuine opportunities for everyone to participate and benefit."[29]

27 U.S. Bureau of Labor Statistics, Employment Situation Summary Table A (April 2011), http://www.bls.gov/news.release/empsit.a.htm (accessed May 7, 2012).

28 United Kingdom.Office for National Statistics, 'Labour Market Statistics, April 2012', http://www.ons.gov.uk/ons/rel/lms/labour-market-statistics/april-2012/index.html (accessed May 7, 2012).

29 Andrew Woodcock, 'Cameron Sets Out Vision for 'Popular Capitalism', *The Independent*, January. 19, 2012, http://www.independent.co.uk/news/uk/politics/cameron-sets-out-vision-for-popular-capitalism-6291768.html (accessed May 7, 2012).

Most children growing up in England get used to yellow earthmoving equipment with the letters JCB stenciled on it in black letters. Less well-known is **JCB Academy**, a secondary school sponsored by J.C. Bamford Excavators Limited within the English "Academy" program in Staffordshire.[30] The school opened in 2010 for students between the ages of 14 and 19 who wished to specialize in engineering and business. It plans to expand to approximately 120 students in each of four grades. The curriculum combines theory and practice. Students are required to wear business attire.

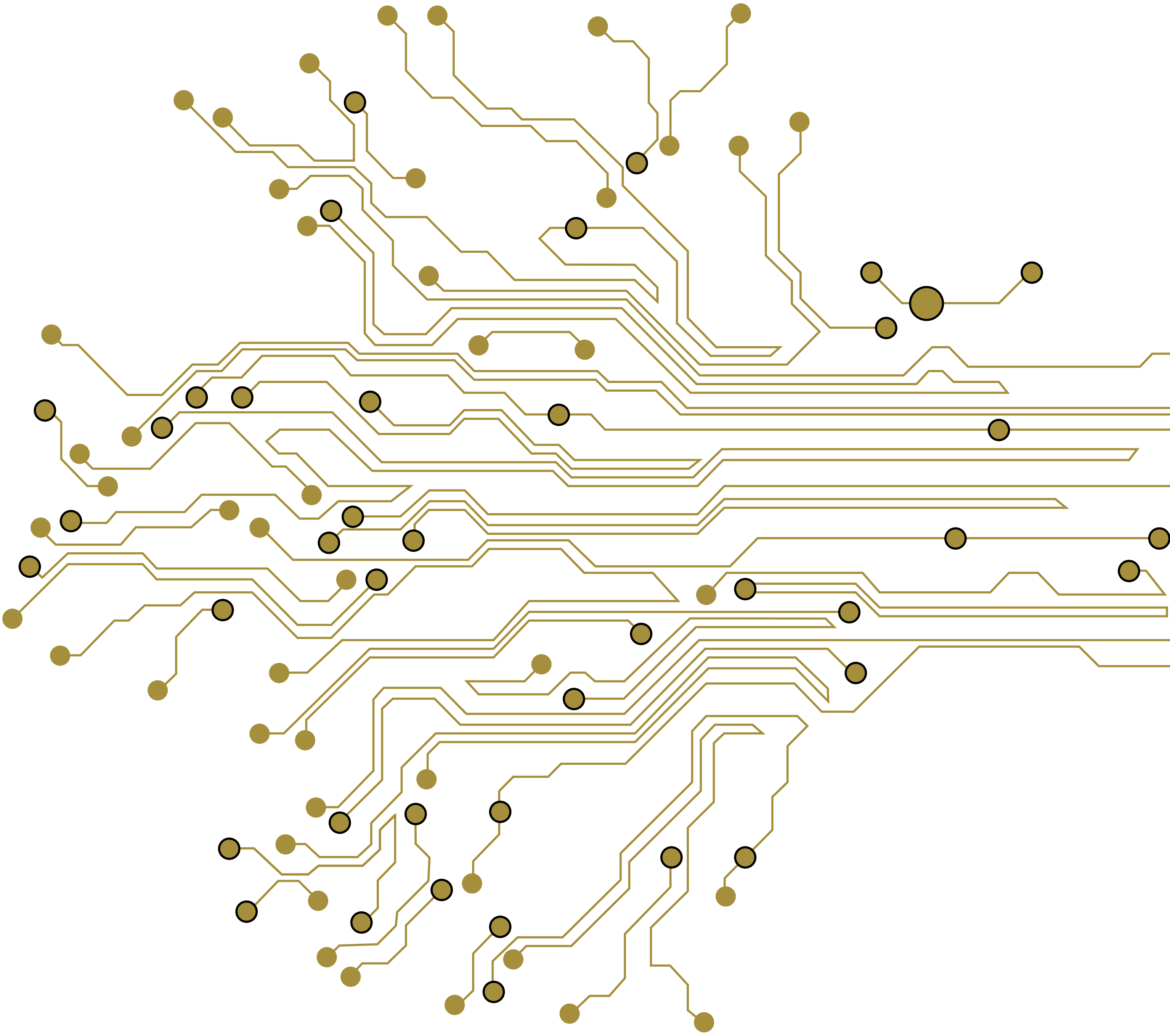
Rolls-Royce has been training young people for employment through its apprenticeship and graduate development programs for over 50 years. Their two-part graduate leadership program trains students in engineering, HR, customer management, operations or finance. With the guidance of individual mentors, each trainee undertakes a series of six-month placements within these fields, one of which must be abroad; then they complete two longer posts to develop leadership skills. There are also programs to develop graduate-level functional expertise as well as technical and practical apprenticeships. There are nearly 1400 graduate trainees and apprentices working at Rolls-Royce. In 2011, the company began constructing a new Apprentice Academy, which will double the number of apprentices it can train each year. Ninety-eight percent of apprentices go on to complete the program and 90 percent go on to achieve higher qualifications. Today, over 40 percent of Rolls-Royce's senior U.K. managers began their careers at the company as graduate trainees or apprentices.

Companies are well aware of the educational challenges that face young people in many of the countries in which they operate and that, for their own sake, they must work to solve them.

Launched by Sir John Peace, Chairman of Burberry, Experian and Standard Chartered, **WORKing for YOUth** is a business-led initiative to reduce levels of youth unemployment in the U.K. by creating more entry-level jobs. It consists of three key strands: asking businesses to increase investment in jobs in their own companies; asking businesses who are unable to create entry-level jobs to donate money to the WORKing for YOUth charity that can be used to subsidise more entry-level roles in sustainable, growing SMEs in the worst hit areas of the country; creating a place on Facebook where young people can find entry-level jobs and receive guidance about the world of work. WORKing for YOUth will work in conjunction with charities working with young people in this area. The overall aim is to create over 200,000 new entry-level roles by 2015, and bring in donations of over £100 million. This should allow WORKing for YOUth to create a significant number of opportunities in the hardest-affected areas.

There are many other efforts, including those at AOL/Year Up, Boeing, BT, Barclays, EMC Corporation, Exxon-Mobil, Ernst & Young, Gap, HSBC, General Motors, Intel, Intercontinental Hotels, McDonald's, Microsoft, Northrup Grumman, Oracle, PepsiCo, Santander, SAP, Texas Instruments, Tesco—and this is just a partial list. But it goes to show that companies are well aware of the educational challenges that face young people in many of the countries in which they operate and that, for their own sake, they must work to solve them.

30 JCB operates a co-educational "non-selective" school to which all applicants who live within a certain area are accepted up to the capacity of the school. An "academy" is a school that is directly funded by central government (specifically, the Department for Education) and independent of direct control by local government in England, however the latter are responsible for the funding formulae used to allocate funds between sections of education within an authority. An academy may receive additional support from personal or corporate sponsors, either financially or in kind. They must meet the National Curriculum core subject requirements and are subject to inspection by Ofsted. Academies are self-governing and most are constituted as registered charities or operated by other educational charities.



PATHWAY 2: NURTURING START-UPS AND SMES

The reader will note that the companies listed above are large ones. They have the resources to look after their own needs. Over 99 percent of U.S. firms are SMEs, and they play a crucial role in job creation. From 1992 to 2010, SMEs accounted for 62 percent of net jobs created in the US.[31] According to the 2007 U.S. Census, they accounted for almost half (48.8 percent) of total employment.[32] By 2010, they accounted for 47.6 percent of non-farm U.S. employment. Since then, more than half of all net new jobs have been created by small businesses.[33] Small businesses are fueling many high growth sectors, such as health care, where they account for 52 percent of total businesses.[34] They also represent nearly a third of the value of U.S. exports.[35]

The situation is the same in the U.K., where 99.9 percent of all enterprises are SMEs.[36] In 2011, 4.5 million SMEs employed 58.8 percent of the private sector, generating over £3,100 billion, or 48.8 percent of private-sector turnover.[37]

Since the economic crisis, however, small businesses have been struggling. Female and minority-led SMEs face particular challenges.[38] A Dun & Bradstreeet report notes that small business failure rates rose by 40 percent between 2007 and 2010 across the United States.[39] Exhibit 3 shows this—and also the fact that the start-up rate is only modestly higher than 20 years ago—a period in which the U.S. population increased by over 50 million.

Over the same three years, according to Eurostat, the statistical office of the European Union, the proportion of unsuccessful loan applications by SMEs rose in almost all member states. The highest percentages of unsuccessful applications were found in five countries, including the United Kingdom, at 21 percent.[40] As far as the U.S. is concerned, Exhibit 4 shows how much tighter lending still is compared to pre-recession levels.

Of course, many SMEs exist only because they serve the economy's larger businesses, so the numbers can be misleading. Nevertheless, a very significant portion of the U.S. and U.K.

31 Kevin L. Kliesen and Julia S. Maues, 'Are Small Businesses the Biggest Producers of Jobs?', The Federal Reserve Bank of St. Louis, April 2011, http://www.stlouisfed.org/publications/re/articles/?id=2087#endnotes (accessed May 7, 2012).

32 U.S. Census Bureau, *Statistics of U.S. Businesses*, 2007 and *Nonemployer Statistics,* 2007. U.S. Census Bureau

33 U.S. Bureau of Labor Statistics, 'Quarterly Data Series on Business Employment Dynamics, Table 4., Private Sector Gross Job Gains and Losses', (economic news release May 1, 2012)" http://www.bls.gov/news.release/cewbd.t04.htm (accessed May 7, 2012).

34 Kathryn Kobe, 'Small Business GDP: Updates 2002-2010', the Small Business Administration, January. 2012, http://www.sba.gov/sites/default/files/rs390tot_1.pdf (accessed May 7, 2012).

35 U.S. International Trade Commission, *Small and Medium-Sized Enterprises: Overview of Participation in U.S. Imports*, Investigation No. 332-508, USITC Publication 4125, January, 2010.

36 The definition of SME varies between the U.S., the U.K. and Europe. In the U.S., SMEs often refer to companies with 500 employees or less, depending on the industry. In the U.K., the number is 250 or less. The number varies across Europe.

37 United Kingdom Department for Business Innovation and Skills, '"Business Population Estimates for the UK and Regions 2011, Statistical Release' ," Department for Business Innovation and Skills, October. 12, 2011, http://www.bis.gov.uk/assets/biscore/statistics/docs/b/bpe_2011_stats_release.pdf (accessed May 7, 2012).

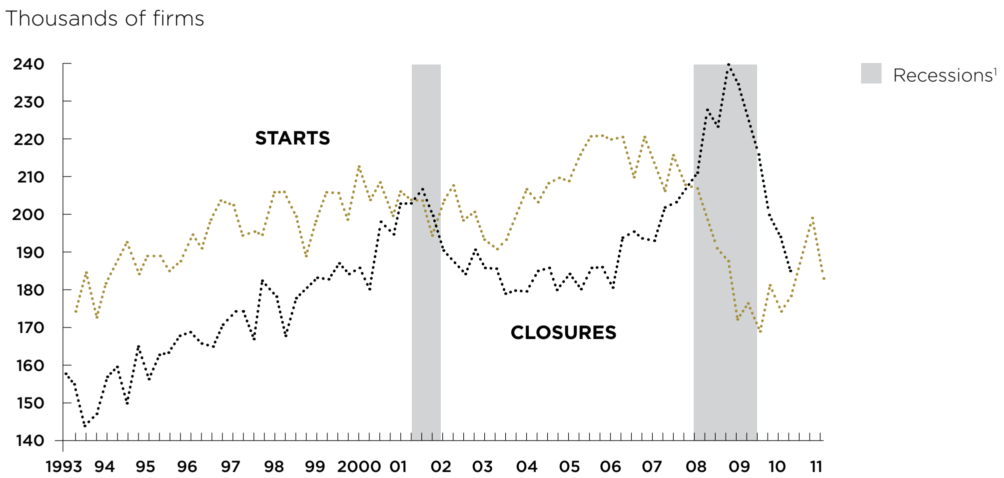
38 United Kingdom Department for Business Innovation and Skills. *Helping Small Firms Start, Grow and Prosper*. BusinessLinkGov. January 2011. http://www.businesslink.gov.uk/Horizontal_Services_files/bigger_better_business.pdf (accessed May 6, 2012). A study by the U.K.'s Department for Business Innovation and Skills notes that "Women make up 51 per cent of U.K. population and 46 per cent of the economically active. But women constitute only 29 per cent of the self-employed in the U.K. If the U.K. had the same level of female entrepreneurship as the U.S., there would be approximately 600,000 extra women-owned businesses, contributing an estimated additional £42 billion to the economy. If women started businesses at the same rate as men, there would be an additional 150,000 extra start-ups each year in the U.K." The study also discusses low rates of entrepreneurship among a number of ethnic minorities.

39 Catherine Clifford, 'States With Worst Business Failure Rates', CNN Money, May 20, 2011. http://money.cnn.com/2011/05/19/smallbusiness/small_business_state_failure_rates/index.htm. (accessed May 2, 2012).

40 Eurostat, 'The Proportion of Unsuccessful Loan Applications by SMEs Has Risen With the Economic Crisis', news release, October 3, 2011.

EXHIBIT 3

NOT JUST 'NORMAL CHURN': BUSINESS STARTS AND CLOSURES OVER THE LAST TWO DECADES

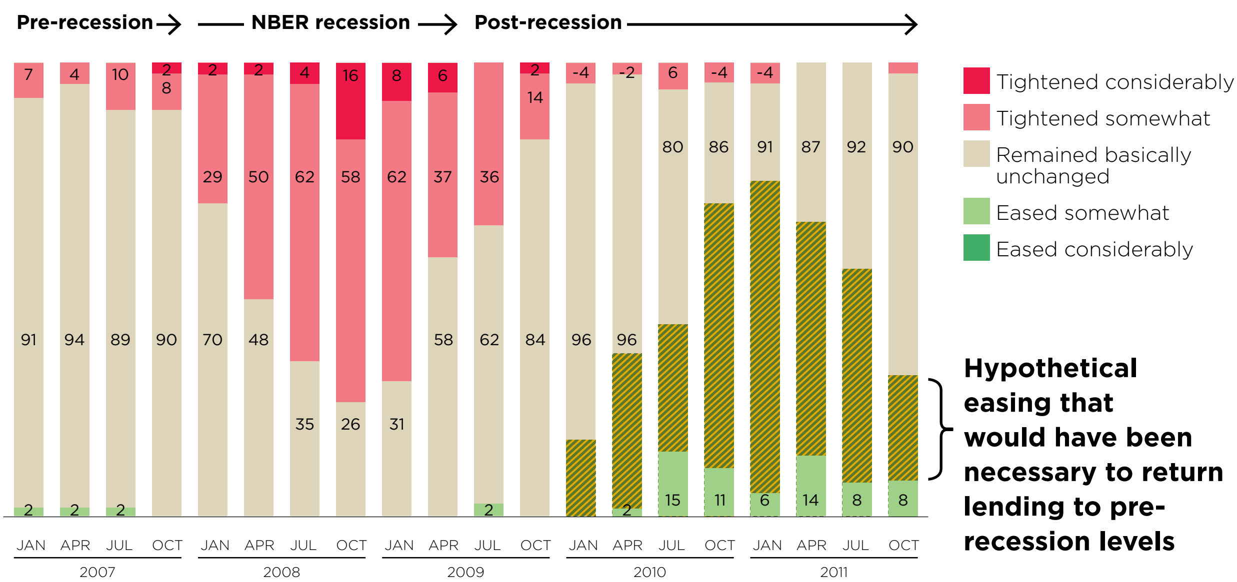


[1] NBER PEAK TO TROUGH BUSINESS CYCLE [3/01 – 11/01, 12/07 – 6/09]
SOURCE: BLS BUSINESS EMPLOYMENT DYNAMICS

EXHIBIT4

FINANCING TIGHTENED FOR SMALL FIRMS DURING RECESSION

PERCENTAGE OF BANKS SURVEYED (CHANGE LAST THREE MONTHS)



SOURCE: FEDERAL RESERVE BOARD SENIOR LOAN OFFICER OPINION SURVEY ON BANK LENDING PRACTICES, 2007-PRESENT, NBER economies consist of SMEs that struggle because they do not have the resources to help themselves in the way large companies can. As it happens, governments in many countries, and particularly in the U.K., have recognized the particular pressures SMEs have been under since the crisis, and are taking action accordingly—something broadly noted in the press. Less noticed is how large companies can promote and indeed are promoting the growth of SMEs in three interrelated ways: By spending more money with them, by working to increase SMEs' success rate as suppliers, and by improving their access to capital.

Large companies already spend a lot of money with SMEs. In 2010, the Business Roundtable, an association of CEOs of leading American companies, found that U.S. multinationals purchased inputs for their products and services from an average of over 6,000 businesses that each employed fewer than 500 workers. In total, U.S. multinationals spend about $1.5 trillion each year on goods and services from small business suppliers.[41]

This is an enormous amount of money—but it is only 12.3 percent of total U.S. SME revenue, and about a quarter of what U.S. multinationals spend.[42] This figure is significantly smaller than the proportion of the economy represented by SMEs, so there would appear to be a great deal of room for this figure to increase.

What stands in the way? SMEs find it hard to operate in ways that make them successful suppliers to very big companies; and they are often constrained in the nature and scale of their operations because of difficulty in accessing credit.[43]

At the heart of SMEs' problems in becoming and remaining successful suppliers is that their fluid business structures do not match the more rigid ones of their large potential customers. Large companies often have similar corporate structures to one another, which makes relationships between them easier to manage. In contrast, small companies find it hard to locate the right decision maker in a complex corporate structure and to get decisions made and acted on. They also find it hard to get paid within a timeframe that makes it possible for them to avoid borrowing money (and so having to make interest payments out of any profit on the transaction). And they can only get this far if they *can* raise the capital they need, which is difficult because they themselves have limited collateral.

Not surprisingly, the bigger the customer, the more difficult the challenges can be, particularly if the larger player makes no special accommodation to its new supplier. Fortunately, a number of large companies have already taken it upon themselves to help smaller companies become part of their supply chain. Here are three British and American examples of companies or groups of companies committed to buying more from SMEs, making it easier for them to succeed as suppliers and, in at least one case, providing financing where needed.

HP UK, the British arm of the technology company with a portfolio that spans printing, personal computing, software, services and IT infrastructure, has committed to increase the volume of business supplied by SMEs in its supply chain from 10 percent to 15 percent by the end of 2013, and to increase the number of SMEs it does business with from 600 to 750. Among many other things, the company has already deployed a company-wide program to make it easy for SMEs to engage with HP, to work with SMEs to broker new routes to market for them, and to invest to help their customers drive innovation. It has appointed an SME

41 Matthew J. Slaughter, 'Mutual Benefits, Shared Growth: Small and Large Companies Working', Business Roundtable, September 13, 2010, http://businessroundtable.org/uploads/studies-reports/downloads/Small_Big_Business_Report_FINAL.pdf (accessed May 7, 2012).

42 Ibid, 3.

43 Kate McMillan, *Canadian SMEs and Globalization: Success Factors and Challenges* Conference Board of Canada, May 2008. This study based its findings on a literature review; a survey of over 70 SME owners and managers; three multi-stakeholder roundtables with 45 representatives from MNCs, SMEs, industry groups, research institutions, and government agencies; and 20 interviews with MNCs, SMEs, and other stakeholders with an interest in the success of MNC-SME value chains.

Champion to advocate for SMEs within HP and externally, signed the U.K. government's "prompt payment code", and developed a cloud-based system to allow SMEs to scale their technology products and services to public-sector customers.

THE SUPPLIER CONNECTION was created by the IBM Foundation. Its founding members include AMD, AT&T, Bank of America, Caterpillar, Citigroup, Dell, Facebook, IBM, John Deere, JPMorgan Chase, Kellogg's, Office Depot, Pfizer, UPS, and Wells Fargo. Launched in 2011, it provides a web-based solution to improve SMEs' access to global businesses. The website provides a standardized, streamlined way to register their information and connect with businesses large and small—and in turn allow large companies to find registered suppliers quickly.

Capitalism thrives best when barriers to the growth of new companies are lowest. The nurturing of SMEs by the large companies that can offer them so much business is one of the best ways to keep the barriers low.

THE SUPPLY CHAIN INITIATIVE, coordinated by the University of Cambridge Program for Sustainability Leadership, was formed to support the standardization of environmental, social and governance (ESG) reporting metrics. Many large companies now require suppliers to provide an array of ESG information, and a standard request for information will obviously help to simplify the process and guide SMEs in their internal sustainability and ESG processes, making it easier for them to qualify as suppliers. Companies participating in the Initiative included BT Group, EDF Energy, Kingfisher, Lloyds Banking Group and Marks & Spencer.[44]

In addition, companies such as AT&T, IBM, Boeing, Chrysler, Dell, Ford and GM spend more than $1 billion a year buying goods and services from businesses owned by women or minorities, many of which are SMEs.

Capitalism thrives best when barriers to the growth of new companies are lowest. The nurturing of SMEs by the large companies that can offer them so much business is one of the best ways to keep the barriers low.

44 University of Cambridge Program for Sustainability Leadership, 'The Purpose of the Supply Chain Initiative', http://www.cpsl.cam.ac.uk/Collaboratories/Previous-Collaboratories/Supply-Chain-Initiative.aspx (accessed May 6, 2012).

PATHWAY 3: REFORMING MANAGEMENT AND GOVERNANCE PRACTICES TO COUNTER SHORT-TERMISM

Corporate governance failed dramatically in a number of cases in the recent crisis. It did so in two ways. First, and most fundamentally, company executives managed their companies to a short-term notion of shareholder value rather than long-term health. Second, boards of directors—by their own candid admission—paid more attention to corporate compliance than to evaluating their company's strategy for creating value over the long term.

Managing to shareholder value, which became widespread during the 1980s, has fallen from grace in favor of a broader notion of stakeholder value. But it is possible to be a supporter of shareholder-value maximization and still identify a major problem. During the last 30 years, the market has gone through structural changes that have caused investment capital and equity markets to become impatient about performance. Shareholder value has come to mean short-term shareholder value. Pressure to maximize shareholder value really means creating value every quarter.

There has been a radical decline in the number of investors holding stocks for long periods. In 1960 in the U.S., the average NYSE holding period was eight years. In 2010 it was only four months.[45] The change in the U.K. is even more dramatic (Exhibit 5). Many large shareholders are passive shareholders, moving their money in and out of stocks as companies move into and out of this or that index. And computer program trading sometimes shortens stock holding times to milliseconds.

The result of having to answer to investors (or computers) ready to pull their money out at the slightest wobble in the share price is obvious: managers devote most of their energies to meeting their quarterly targets. In such an environment, the long-term will always be sacrificed to the short term, and the urgent will drive out the important. Needless to say, if a great deal of managers' compensation is linked to short-term company performance, the situation will be exacerbated.

The fate of company investment in a short-term world offers a good example of the problem. Research by economists John Asker, Joan Farre-Mensa and Alexander Ljungqvist found that public companies invested just four percent of their total assets compared to 10 percent for "observably similar" privately-held companies. In addition, private firms were 3.5 times more responsive to changes in investment opportunities than public firms.[46]

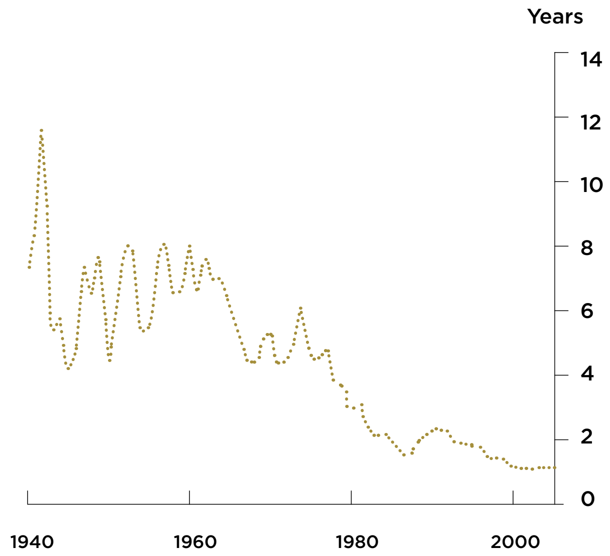
45 Andrew Haldane, 'Patience and Finance', (presentation, Oxford China Business Forum, Beijing, September. 9, 2010).

46 John William Asker, Joan Farre-Mensa, and Alexander Ljungqvist, 'Comparing the Investment Behavior of Public and Private Firms' (Finance Working Paper, ECGI, March 14, 2012). http://ssrn.com/abstract=1603484 (accessed May 6, 2012).

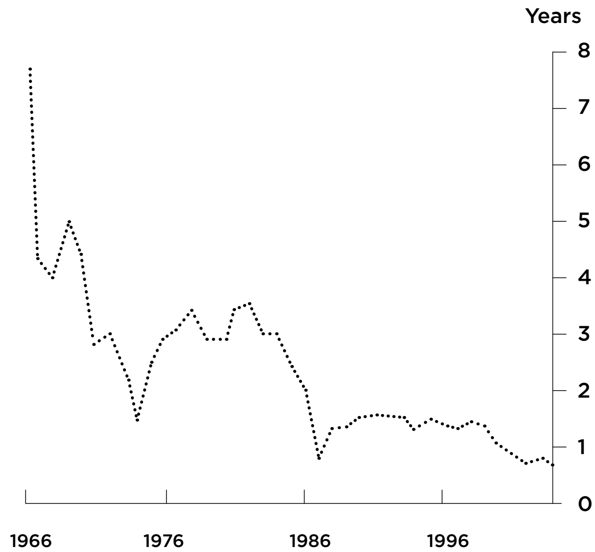
EXHIBIT 5

AVERAGE STOCK HOLDING PERIODS HAVE DECREASED SIGNIFICANTLY IN BOTH THE U.S. AND THE U.K.

NYSE average stock holding period[1]



FTSE average stock holding period[1]



[1] Estimated by looking at the ratio of the market value of the shares outstanding to the value of shares traded in any given year.

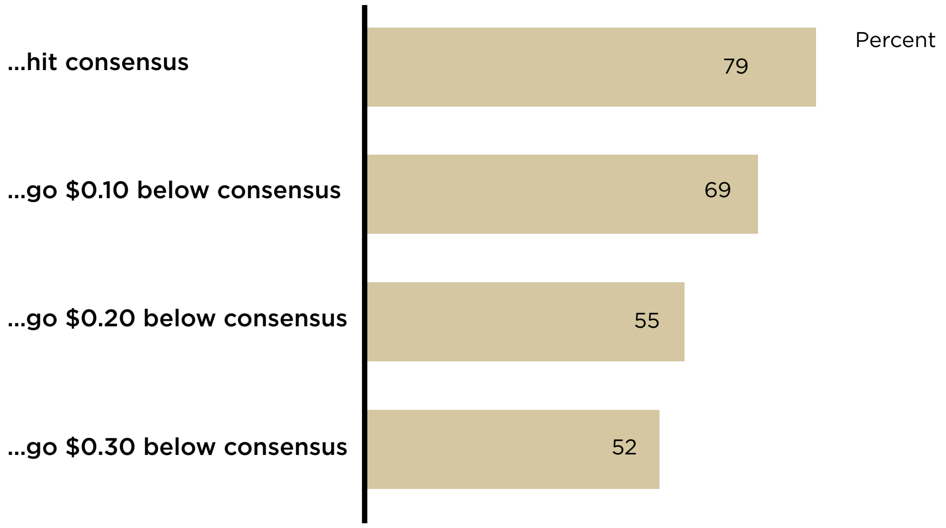
SOURCE: ANDY HALDANE, PATIENCE AND FINANCE, SEPTEMBER 2010; NEW YORK STOCK EXCHANGE; LONDON STOCK EXCHANGE

Exhibit 6 shows how managers become progressively less willing to invest *in an NPV-positive project* as it lowers earnings per share in ten-cent increments.

EXHIBIT 6

RESEARCH SUGGESTS MANY CFOS BELIEVE THEIR COMPANIES SACRIFICE VALUE TO HIT QUARTERLY EARNINGS TARGETS

What is the probability that your company invests in an NPV-positive project if, as a result, quarterly EPS...



Note: Based on survey conducted on ~400 CFOs

SOURCE: GRAHAM, HARVEY, RAJGOPAL "VALUE DESTRUCTION AND FINANCIAL REPORTING DECISIONS", 2011

It might be expected that boards of directors would act as a brake on this kind of behavior. In fact, board directors, surveyed anonymously, admit they have not fully performed their job in this regard—although they would like the information and the time to do better. Responding to a recent McKinsey survey, many directors reported that the boards they sat on did not increase the time spent on company strategy after the crisis. Nearly half of respondents said their boards simply reviewed and approved management's proposed strategies. And 79 percent of the same group admitted that they did not completely understand their companies' current strategy.[47] It's hard to improve something you don't understand. And if you can't influence strategy, you can't do much more than talk about tactics—once again, the short term over the long term.

Not surprisingly, we believe the answer to these three problems is to encourage long-term thinking on everybody's part. Companies can encourage long-term investing by ceasing to offer quarterly earnings guidance, as many now have—including such long-established companies as Unilever, AT&T, Merck, GE and IBM. In a related effort to attract long-term investors, IBM created a 2015 "roadmap" that communicates a story about longer-term growth.

Another option that has been used by a small number of companies is to provide greater

47 'Governance Since the Economic Crisis: McKinsey Global Survey Results', *McKinsey Quarterly*, July 2011, https://www.mckinseyquarterly.com/Governance_since_the_economic_crisis_McKinsey_Global_Survey_results_2814 (accessed May 7, 2012).

rewards to investors who hold shares for a longer period of time. As long ago as 1991, for example, after a dividend cut, Michelin granted one call-warrant for every 10 shares held on December 24, 1991. The warrant could be exercised four years later at nearly double the share price at the time of the announcement. More recent examples include L'Oreal's offer of a loyalty bonus to registered shareholders (proposed at the annual general meeting of April 16, 2009), which grants a 10 percent incremental dividend to all shareholders having held registered shares for at least two years, up to a limit of 0.5 percent of nominal capital per shareholder. Air Liquide offered both a dividend and share bonus to all shareholders who kept their shares for at least two years.[48]

We offer advice to investors in line with that offered here to companies. We believe that the pension funds, insurance companies, mutual funds and sovereign wealth funds that together hold $65 trillion, or roughly 35 percent, of the world's financial assets, should create long-term investment portfolios consisting of larger shares of a smaller number of companies (and should reward their asset managers on the basis of their long-term performance, too!).[49] This gives them a greater voice in the management of these firms—which they will use with an eye to the long term, as that will be their horizon.

A company managing value for the long term is also likely to take a more enlightened view of CEO compensation. We do not begrudge CEO compensation when it has been demonstrably earned and reflects market realities. Indeed, this is an essential facet of capitalism. However, there is no doubt that in some cases, compensation decisions taken in relation to short-term criteria have not reflected the long-term interests of the companies concerned, and have negatively affected perceptions of the vitality of our economic system as a whole. Cases such as these erode popular support for capitalism, precisely to the extent that compensation and severance packages are out of line with the performance of the company concerned and of the national economy—both as to absolute numbers and the rate of increase.

There is clearly significant room for improvement in this regard if CEO compensation is once again to be viewed as a badge of pride rather than suspicion.

As for the board room, it should be clear that a shift on the part of the company and of investors to a long-term view will be echoed there. McKinsey's global governance survey suggested that directors are already complaining that the information they get is too short term in its focus.[50] Directors who describe their boards' overall performance as excellent or very good are happier about the timeframe of the information they receive. Boards are also expressing a desire to spend more time on strategy than on shorter-term issues.

The **Ontario Teachers Pension Plan (**OTPP), which administers approximately $120 billion in pension assets for 300,000 active and retired teachers, principals and school administrators in Ontario, Canada, has long been an advocate of improved corporate governance. It has adopted an investment strategy that focuses on managing its investment and funding risks through long-term holdings, asset diversification and liability hedges. OTPP partners with a limited number of companies by making significant, influential equity investments, and seeks to support or improve management and governance or both, in order to promote significant value creation over time.

48 Patrick Bolton and Frederic Samana, 'l-Shares: Rewarding Long-Term Investors', (preliminary draft, Columbia University, August 2010). This article describes these and other examples. http://cgt.columbia.edu/files/papers/Bolton_Samama_L-Shares-Rewarding_Long-Term_Investors.pdf (accessed May 6, 2012).

49 Raffaele Della Croce, Fiona Stewart,and Juan Yermo, 'Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies', *OECD Journal: Financial Markets Trends,* no. 12, vol. 2011, no.issue 1, pp. 145-164.

50 *Governance Since the Economic Crisis,* 5.

Amazon has long been willing to spend on investments with long-term payoffs at the cost of maintaining low operating earnings. The company has done little to dampen speculation that it sells some important products at a loss. Jeff Bezos, the CEO, says, "At Amazon, we like things to work in five to seven years." The CFO says, "We think of the lifetime value of those devices."[51]

The Netherlands-based pension administrator **PGGM** set up a Responsible Equity portfolio in 2009 with total commitments of €3 billion. It aims to invest in 15-20 companies and the mandate was created with an initial three-year lockup to stimulate a long-term investment perspective. In addition to a rigorous private equity-style financial analysis, it has developed an 80-point index to measure investments based on environmental, social and governance metrics. The portfolio uses its stakes in companies to influence management and encourage them to create long-term value.

If the management and boards of companies can adjust their sights to the further horizon, along with large investors, we believe many of the problems of corporate management and governance will be solved.

THE QUESTION OF ETHICS

When the crisis hit, the public's anger focused on large financial institutions. Since then, we have witnessed a public debate on business integrity that has broadened to include many industries. Protest movements such as 'Occupy Wall Street' gesture at the wider loss of confidence in business both in terms of what it can deliver—jobs, social mobility and so on—and with regard to how business is practiced.

The Henry Jackson Initiative on Inclusive Capitalism is still at the beginning of its work on programs that will encourage higher ethical standards of business practice. But some preliminary observations are in order.

First, it is our belief that the recommendations in the previous section of this paper will help in dealing with the problem. Longer-term investors, a reduction in the importance of quarterly earnings guidance, and sharper-eyed directors will go a long way towards urging companies to think about their reputation over a period of years rather than months. People behave better when they take a long-term perspective.

Second, today, shareholders are paying more attention to what is happening at the companies in which they have holdings. The companies themselves are, too. CEO compensation has fallen significantly at many institutions, and shareholders are pushing back in a number of countries on companies where they feel CEO compensation is not being adjusted to the less-than-stellar performance of their companies.

All that said, however, a hard truth needs to be recognized: people will not behave ethically unless they are working within an ethical company culture. As we noted at the beginning of this paper, most of the actions people took that helped exacerbate the 2008 crisis were not illegal. The number of cases in which people broke the rules is far outweighed by the number in which people behaved unethically within them.

Herein lies the danger of making everything "rules based". Essentially, moral responsibility is removed from the individual. Like it or not, we need, in many cases, a change in company

51 James B. Stewart, 'Amazon Says Long Term and Means It', *New York Times*, December 16, 2011. http://www.nytimes.com/2011/12/17/business/at-amazon-jeff-bezos-talks-long-term-and-means-it.html?pagewanted=all. (accessed May 2, 2012).

culture, a long-term process that requires senior management support. We need to create company cultures and a larger business culture in which people ask not “Can I do this?” but “Should I do this?” At the risk of sounding touchy-feely, we need to think about ways of bringing “the whole individual” into the work place.

Education is the crucial starting point. Many businesses have codes of ethics or conduct, and the teaching of ethics within business schools is widespread. But it was widespread before the crisis, and a great deal more energy needs to be invested here.

Only if people become more aware of the moral dimension of their personalities, and bring it into their business decisions, will we avoid a repetition of the problems we have suffered. It is a tall order. Perhaps the recognition that, if companies do not do this for themselves, others will do it for them will be sufficient to provoke a reaction.

In light of this, the Initiative intends to start a program focused on business ethics that will include analysis of the adoption of ethics training in firms; assessment of the value of that training; teaching about the theoretical underpinnings of ethical standards within society and their relation to business practice; determination of best-practice models for corporate implementation of ethics; and ongoing development of industry- and firm-specific case studies and curricula for the teaching of ethics.

Perhaps this seems at odds with the notion of a capitalism driven by self-interest. We believe not. But it is crucial to understand self-interest broadly, not narrowly. Adam Smith noted that we begin with a strong self-regard that motivates a desire for praise and recognition. We believe this provides a strong basis for revitalising individuals’ and businesses’ ethical standards in a way that is practically applicable within the work place.

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CONCLUSION

Over the past four years, the Western capitalist system has undergone a very public, protracted and brutal mauling on a scale not seen since the Great Depression of the 1930s. Given the widespread effects of the recent economic crisis, this attack is entirely to be expected. We live in free societies, and the right to question any and all assumptions is part of what has made democratic capitalism great. Indeed, our taskforce has joined in that spirit of questioning.

However, there comes a point in all public debates when the balance of criticism swings from constructive to destructive. We believe we may now be at such a point. Economic populism serves a certain purpose, but it is at its best when tempered by pragmatic and reasonable responses from all groups in society. By chipping away at our confidence in business to generate economic growth, and encouraging the belief that state regulation may be the answer, we are in danger of weakening our economies precisely when the challenges of globalization demand we strengthen them.

We believe that the better solution is a self-imposed solution. Business must acknowledge the problems of the past, and indeed the present, while maintaining its energetic ability to deliver a brighter economic future for all. We call this inclusive capitalism, and have sought in this report to illustrate that it is, for all its flaws, the economic system that delivers the greatest good to the greatest number.

The Henry Jackson Initiative for Inclusive Capitalism is committed to becoming a center for the development of inclusive capitalism through business leadership and policy in the 21st century. We will work in the U.K. and the U.S. to promote discussion about the benefits of capitalism and how they can be shared most broadly. Starting with this white paper and our website (www.henryjacksoninitiative.org), our first priority is to identify and disseminate the strongest examples of progress along the three pathways we have identified in this paper and to showcase companies that have developed and are implementing programs that benefit both business and society.

The essence of our argument is that business is already taking the lead in the areas that most need improvement and must continue to do so. We will regularly update our website with descriptions of the most instructive initiatives we can find. We will continue to highlight the private sector's work to show that businesses can achieve greater efficiency, competitiveness and success without sacrificing sustainability or the public good. We are grateful to all the companies and organizations highlighted in this report for the leadership they have shown. And we are excited about a future in which the private sector continues to engage more deeply in the fulfillment of its obligations to the entire community.

We will do all we can to champion the programs of these companies, institutions and individuals around the world. We believe the Initiative will show that as long as industry, innovation and enterprise are anchored by inclusivity, ethics and responsibility, the capitalist system will continue to make our societies great and garner the widespread public support that it deserves.

TASK FORCE BIOGRAPHIES

DOMINIC BARTON, CO-CHAIR

Dominic Barton is the Global Managing Director of McKinsey & Company. In his 25 years with the firm, Dominic has advised clients in a range of industries—including banking, consumer goods, high tech and industrial—but his core area of work is in financial sector development and reform.

Prior to his current role, Dominic was McKinsey's Chairman of Asia from 2004 to 2009, based in Shanghai, and he led McKinsey's office in Korea from 2000 to 2004.

LADY LYNN FORESTER DE ROTHSCHILD, CO-CHAIR

Since June 2002, Lady de Rothschild has been the Chief Executive of E.L. Rothschild LLC, a private investment company with investments in media, information technology, agriculture and real estate. Holdings include The Economist Group (U.K.), Weather Central LP (U.S.), real estate and financial instruments. Lady de Rothschild has been a director of The Estee Lauder Companies since December 2000, The Economist Newspaper Limited (member of the Audit Committee) since October 2002 and Weather Central LLP since January 2011. She is a director of the Peterson Institute of International Economics and an active member of the Council on Foreign Relations (U.S.), Chatham House (U.K.) and the Institute for Strategic Studies (U.K.). She is a graduate of Pomona College and has her J.D from the Columbia University School of Law.

SAMUEL DI PIAZZA, JR.

Mr. Di Piazza joined Citi in 2011 as a Vice Chairman in the Institutional Clients Group. He is a member of the Senior Strategic Advisory Group, which includes some of Citi's most senior and experienced bankers. His client service crosses multiple industry sectors, including consumer, technology, energy and services across all geographies. In his service to clients, Mr. Di Piazza is engaged in advisory services in mergers & acquisitions, debt and equity offerings and capital market transactions.

Mr. Di Piazza retired as Global Chief Executive Office of PricewaterhouseCoopers International Limited (PwC) in September 2009, after serving in the role since January 2002.

CARLY FIORINA

Carly Fiorina worked her way through undergraduate and graduate school and began her business career as a secretary for a small business. She became the first woman to lead a Fortune 20 company, serving as the Chairman and Chief Executive Officer of Hewlett Packard from 1999 to 2005. Carly led the reinvention of this legendary company, tripling its rate of innovation, achieving market leadership, transforming its cost structure and accelerating growth.

Today, Carly is one of the most recognized business leaders in the world and an opinion leader who champions innovation, competitiveness and job creation.

LORD GAVRON CBE

Lord Gavron was educated at Leighton Park School, Oxford University and the Middle Temple. He founded St Ives in 1964 and retired from it in 1993. Since then he has been on the board of The Royal Opera House, The National Gallery and Guardian Media Group where he was Chairman. He has been owner and Chairman of The Folio Society since 1982.

ROBERT GREENHILL

With a strong interest in global issues, Robert has combined a senior career in international business with an ongoing commitment to international public policy. He started his career with McKinsey & Company. In 1995, he joined Bombardier Inc., where he occupied increasingly senior posts, becoming President and Chief Operating Officer of Bombardier International. In 2005, he was appointed President of the Canadian International Development Agency (CIDA). In 2006, UN Secretary-General Kofi Annan appointed him to the High-Level Panel on System-Wide Coherence, which delivered the path-breaking "Delivering As One" report the following year. In 2008, he became Managing Director and Chief Business Officer of the World Economic Forum.

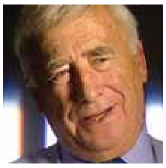
NOREENA HERTZ

Noreena Hertz is Professor of Globalization, Sustainability and Finance at the Duisenberg School of Finance, RSM, Erasmus University, and an Associate Director of the Centre for International Business and Management, Judge Business School, University of Cambridge. She is also a Fellow of University College London. Her books *The Silent Takeover* (2001) and *IOU: The Debt Threat* (2005), were both bestsellers.

Noreena played an influential role in the development of (RED), an innovative commercial model to raise money for people with AIDS in Africa, and advises major multinational corporations, CEOs, NGOs and politicians, as well as start-up companies, and sits on various corporate and charitable boards.

JON HUNTSMAN JR.

Jon Huntsman served as Ambassador to China from 2009 through April 2011 when he stepped down to run for the 2012 Republican nomination for President. Prior to serving as Ambassador to China, Huntsman was twice elected as Governor of Utah, including in 2008 with a record percent of the vote, including the majority in all 29 counties. As Governor, Huntsman governed with his eye toward maintaining Utah's unparalleled quality of life, continually increasing the state's economic competitiveness and maximizing funding to Utah's public education system.



LORD KALMS

Lord Kalms built the Dixons Group into one of Europe's leading electronic retailers employing 40,000 colleagues. He was awarded a Life Peerage in June 2004. He is Chairman of the Strategy Committee of The Henry Jackson Society.

He funded several business ethics programmes, including a Chair in Business Ethics at the London Business School. Lord Kalms has also served as Chairman, King's College Healthcare NHS Trust; non-executive Director of British Gas plc; Former Governor of NIESR; Founding Director of Business for Sterling; Founder and sponsor of the Dixons Bradford City Academy. He was also the Treasurer of Conservative Party (2001-2003).

JIM LEECH

Jim Leech was appointed President and CEO of the Ontario Teachers' Pension Plan (Teachers') in 2007. With $117.1 billion in assets as of December 31, 2011, Teachers' is the largest single-profession pension plan in Canada. It invests the pension fund assets and administers the pensions of Ontario's 300,000 active and retired teachers.

Mr. Leech joined the organization in 2001 to lead the private equity department, Teachers' Private Capital. He is recognized for his expertise in the private equity industry and has been CEO of several public companies. Mr. Leech serves on the boards of Toronto General and Western Hospital Foundation and the MasterCard Foundation.

CHARLIE MAYFIELD

Charlie Mayfield became the John Lewis Partnership's fifth Chairman in March 2007. He joined the Partnership in 2000 as Head of Business Development, becoming Managing Director of the John Lewis division in January 2005. Before joining the Partnership Charlie worked for SmithKline Beecham and McKinsey & Co.

Charlie is the Government appointed Chair of the U.K. Commission for Employment and Skills.

ALAN MENDOZA

Alan Mendoza is a Founder and the Executive Director of the Henry Jackson Society, the parent body of the Henry Jackson Initiative. He directs analysis, research focus, strategy and development for the organisation and has worked to develop relationships and ideas between political networks in the United Kingdom, United States and Europe. He is a Fellow of the Royal Society of Arts, and a frequent commentator on international issues in global media.

ADAM POSEN

Adam Posen joined the Bank of England's Monetary Policy Committee on September 1, 2009. He is also a senior fellow at the Peterson Institute for International Economics, which he joined in 1997. His policy and research work focuses on macroeconomic policy and performance, European and Japanese political economy, central banking issues, and the resolution of financial crises. He is in his third two-year term as a member of the Panel of Economic Advisers to the U.S. Congressional Budget Office.

STUART RODEN

Stuart is a Senior Limited Partner of Lansdowne Partners Limited Partnership and co-manages the U.K. hedge fund ($8 billion under management). Prior to this Stuart was a Managing Director of Merrill Lynch Investment Management (MLIM) and before that he was a Management Consultant at McKinsey & Co.

Stuart received a 1st class honours degree in Economics (BSc) from the London School of Economics in 1984. Stuart is involved in a number of philanthropic organisations both in the UK and abroad and sits on investment committees of several endowments/charities.

JOE SCHOENDORF

Joe Schoendorf is a Venture Partner for Accel Partners, where he has been for over 20 years. He has been active in high-technology industries for 45 years. Joe is a member of the World Economic Forum, where he serves on Foundation Board of Directors, the Executive Committee and the U.S. Board. Previously, Joe was the VP of Marketing for Apple Computer.

LAWRENCE H SUMMERS

Lawrence H. Summers is President Emeritus of Harvard University. During the past two decades he has served in a series of senior policy positions, including Vice President of Development Economics and Chief Economist of the World Bank, Undersecretary of the Treasury for International Affairs, Director of the National Economic Council for the Obama Administration from 2009 to 2011, and Secretary of the Treasury of the United States, from 1999 to 2001.

He is currently the Charles W. Eliot University Professor at Harvard University. He and his wife Elisa New, a professor of English at Harvard, reside in Brookline with their six children.

LORD TUGENDHAT

Lord Tugendhat is a member of the House of Lords and serves on its Economic Affairs Committee. He is also Chancellor of the University of Bath and serves on the Council of Imperial College, London. He is a former Vice-President of the European Commission and a former Chairman of Abbey National plc, Blue Circle Industries plc, the British Civil Aviation Authority and the Royal Institute of International Affairs (Chatham House). He has also been a Conservative MP and began his career on the Financial Times.

LAURA D'ANDREA TYSON

Laura D'Andrea Tyson is the S.K. and Angela Chan Professor in Global Management at the Haas School of Business, University of California Berkeley. She served as Dean of London Business School (2002-2006), and Dean of the Haas School of Business (1998-2001).

Tyson is a member of President Obama's Council on Jobs and Competitiveness and a member of Secretary Clinton's Foreign Affairs Policy Board. Previously, she was a member of the President Obama's Economic Recovery Advisory Board. During the Clinton Administration, she served as the Chair of the Council of Economic Advisers (1993-1995) and the National Economic Adviser (1995-1996).

BARONESS WHEATCROFT

Patience has spent many years writing about business. She was City editor of *The Times*, editor of the *Sunday Telegraph* and the *Wall Street Journal* Europe. She is now a director of financial company, St James's Place plc, and Fiat SPA, and a member of the U.K. Advisory Board of Chinese telecoms company Huawei. She is a trustee of the British Museum.

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