The Civil Economy[1]

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We speak of “civil society” to describe the array of institutions needed to maintain political democracy. Now, crises in the free enterprise system compel us to frame a parallel notion. Call it the “civil economy.” Its promise is to save globalization from itself, building foundations for a sustainable, inclusive prosperity.

Why do we need a new paradigm? Widespread public discontent over globalization is a symptom of a perilous fault line between the new realities of world capital markets and the increasingly outmoded ways in which traditional elites—both governmental and corporate—make economic decisions. The stability of global commerce may depend on a solution that bridges the gap of mistrust. Market players will have to create what amounts to a new international constitution of economic activity capable of drawing the confidence of publics around the world. Such a civil economy compact, a modern-day equivalent of the Magna Carta, would need to define a fresh balance between society and business.

New understandings are called for because the fundamentals of commerce have changed dramatically and swiftly. Through most of the 20th century, in nearly all countries, the state controlled key marketplace assets—from airlines to banks to utilities. Now, in the wake of the end of the Cold War, and the sweeping privatization and de-regulation that resulted, a host of rookie economic potentates have muscled their way onto the field.

First are giant private sector corporations, the principal inheritors of economic power. Second are their owners, institutional investors such as pension and mutual funds, who sink the savings of tens of millions of individuals into equity. In muscular economies such as the US and Britain they now own some 60 to 75 percent of all equity. A third new power—civil society organizations such as environmental lobbies, business and professional associations and trade unions—is expanding influence, helped strongly by instant Internet communication. All three constituencies are awakening to a striking fact: suddenly, they have displaced politicians and civil servants as the principal drivers of worldwide economic activity.

The architecture of global economic policymaking, however, is an anachronism. It continues to reflect a Bretton Woods-style assumption that marketplace rulemaking is the business exclusively of political leaders. Corporations, shareowners and civil society groups, for instance, are expected to wait patiently outside while the club of diplomats at G-7, International Monetary Fund or World Trade Organization summits decides the framework of commerce. This model is conspicuously out of synch with facts on the ground.

Things are hardly better at the heart of the private sector itself. The architecture of economic management is ill suited to current realities. Corporate executives and controlling owners accustomed to wielding unfettered power are confronting challenges from minority investors local and foreign. Most corporate boards are at sea trying to figure out how to meet fresh pressure to monitor and improve their records on the environment, workplace issues and human rights. Making matters far worse, the governance of many institutional investor funds is equally troubled. People all too often have no influence over how their hard-earned retirement savings are managed. And when such funds themselves are unaccountable, they too readily let torpor or commercial conflicts stop them from doing what they should: protecting their clients' investments by serving as watchdogs against corporate malfeasance. Finally, and damagingly, the very genome of commerce—long-standing accounting principles widely deployed to value companies—fails to include the worth of employee skills and other "intangibles" which have emerged as the pivotal assets of knowledge-economy companies.

This yawning divide between post-World War II tradition and today's reality is eroding the public mandate for economic arrangements that constitute a corporation's implicit 'license to operate.' As more individuals quite rightly ask "Who are these people now running our lives?"—and as they get relative silence in response, we risk a mainstream backlash in many countries far more perilous to growth than stones hurled at McDonalds restaurants.

The bottom line: we are in urgent need of a fresh central organizing principle that takes account of the new shape of economic growth, throws sunlight onto practices now hidden, and enfranchises new constituencies.

New Players

Thus, the civil economy. It is not so much an invention as an original term allowing us to connect the myriad dots of individual developments bubbling up in international enterprise. Interpreting these changes as part of a single phenomenon gives us insights into what is happening, where it is heading and how to help it along.

The global market ideal implicit in a civil economy is one in which institutional owners accountable to their millions of savers push corporations toward sustainable prosperity through socially responsible management. Put as a simple equation, if accountability plus social responsibility equals shareowner value, we achieve the civil economy. But how does a civil economy come about? In a civil society, political parties, an independent judiciary, a free press, impartial law and civic bodies are the core sustainers of democracy. Parallel institutions of a civil economy can be understood as engaged shareowners, independent monitors, credible standards and civil society organizations participating in the marketplace. Change occurs when these agents are mobilized, thus altering the infrastructure and rules, the unwritten constitution, of commerce.

Engaged Shareowners. In civil society, we talk of voters. In a civil economy, we address owners. Today, institutional investors managing the savings of tens of millions of people quietly own vast swathes of the market all over the world. But too many funds shirk their fiduciary obligation to savers and offer unquestioning obedience to corporate authority, even when a company's management is patently flawed. The root cause: most funds fail to meet the bedrock governance standards they increasingly demand of companies. Savers can only rarely discover how their funds behave as owners. Nor do savers normally have a voice in how the funds operate. As a result, many pension plans, mutual funds and unit trusts are inevitably hobbled by conflicts and do little to challenge wayward companies in which they own stock. A mutual fund, for instance, is unlikely to vote shares against a company's management if it wants business from the CEO. That aversion to oversight frees corporations, enabled by somnolent boards, to engage not only in high-volume larceny, as we have seen at Enron, Tyco, Adelphia, Worldcom and others, but in a more corrosive everyday mismanagement of companies' impact on shareowner capital, employees and the environment.

Through voluntary codes, law or regulation, institutional investors must become transparent and accountable. They must disclose regularly what guidelines they use in investing, including whether or not they consider social criteria and how they vote their shares. Outreach to members through the Internet and electronic communications should make this routine. Savers should have a role in selecting trustees of such funds. And trustees should have access to robust, independent training programs, such as those already sponsored by the US Center for Working Capital and the Australian Institute of Superannuation Trustees. At the same time, market regulators should be vigorous in ensuring that funds operate solely in the interests of their clients, rather than for other conflicting business interests.

Some of these reforms have only recently been introduced by statute in the UK, US, Australia, France and Germany. Where implemented, they are spurring funds to play a more active role as owners. That, in turn, has compelled more companies to clean up their management and improve their social responsibility performance.

An especially effective grassroots engine of shareowner engagement is the scrappy band of investor groups representing small individual savers. They include Aktiespararna in Sweden, PSPD in Korea, DSW in Germany, the Investor Protection Association in Russia and the Australian Shareholders Association. National public policies should be shaped to encourage such civil economy institutions, since they often are freer from conflicts to act as watchdogs. Malaysia has even gone so far as to create a state-sponsored Minority Shareholder Watchdog Group to capture for the nation the civil economy benefits of activism.

What are those benefits? Academic and industry studies—three of the most recent by the University of Michigan, Stanford University and McKinsey & Co.—now overwhelmingly show that funds enhance the value of their investments if they are activist players in the marketplace. Benefits also flow to corporates. Companies that respond to watchful shareowners by improving governance can lower their cost of capital. Research further demonstrates that activism—and accompanying improvements in corporate governance—significantly boosts a country's economy. The reverse is likewise true. Countries with poor corporate governance lose out on wealth and jobs. ANZ Bank once calculated that in 1998 alone poor corporate governance cost New Zealand the equivalent of 7% of GDP in shareowner value. In short, a civil economy of engaged shareowners pays.

Independent Monitors. In civil society, we expect the surveillance of a free press and the brawn of an independent judiciary to guard against tyranny. In a civil economy, we need a wide range of monitors that help make corporate behavior transparent so that firms end up advancing the interests of the economy as a whole. Such monitors include, of course, media willing and able to scrutinize boards. Only recently have even prominent newspapers awakened to the impact on society of malignant corporate governance. Until 2001, the *New York Times* did not even use the term except in quotes or with an explanation. They also include fair and vigilant regulators. But, in addition, we need a dynamic, worldwide industry of accountability screeners.

A great many bodies specializing in corporate governance already exist. Among them are the Association of British Insurers, Déminor, European Corporate Governance Service, Manifest and the National Association of Pension Funds in Europe; the Corporate Library, Institutional Shareholder Services and the Investor Responsibility Research Center in the US; Corporate Governance International in Australia; LCV in Brazil. Specialized Internet services have joined them. Witness Hong Kong's webb-site.com, the US's eRaider.com and Australia's Crikey.com. Other firms probe companies on their social, environmental or international security performance. Look at SIRI and Vigeo in Europe; KLD and Conflict Securities in the US; Sustainable Investment Research Institute in Australia; or Corporate Footprint in South Africa.

Some of these monitors have unresolved, and sometimes undisclosed, commercial conflicts of interest of their own. Their "constitutional" obligation in the new market—a message they are hearing more frequently from clients—is to address such tensions openly. But the biggest challenge facing accountability screeners is that many of them are barely commercial. Moreover, a huge number of countries feature no such domestic services at all. That, in turn, reflects the enduring ambivalence many funds—the monitors' potential clients—have had until now about acting as true owners. Fund managers do not want to pay for monitors unless they have to. But more are finding they do have to, thanks to pressure from pension plan trustee boards or investor groups. Britain's Institutional Shareholders' Committee, for instance, declared in a landmark October 2002 statement that funds must either hire outside corporate governance monitors or do the work in-house if they expect to meet fundamental fiduciary standards. In other countries, regulators may act to require monitoring.

A civil economy hinges on the integrity of other intermediaries as well. We have seen the implosion of reputations among broker analysts in the US owing to conflicts of interest with related investment banks. Auditors have been badly tarnished by consulting conflicts. Actions by regulators and the professions must ensure that advice to shareowners is as independent as advertised.

Finally, new civil economy tools are beginning to appear in response to market demand. For instance, commercial services are offering investors quantitative ratings designed to measure a company's governance risk. S&P produces issuer-commissioned ratings. Other firms are developing scorecards for national indices in Australia, Brazil, Greece, France, India, Korea, Poland, Russia, and the US. Déminor rates European blue chips. And GovernanceMetrics International[2] is pioneering worldwide risk ratings using more than 600 data points per company. For the first time, portfolio managers now have on their screens the ability to define "investment grade governance" when making buy and sell decisions. And companies are able to benchmark their own accountability practices against peers at home or anywhere in the world.

Credible Standards. Civil society depends on a web of law derived with the consent, and attuned to the social environment, of the electorate. In the world of owners, the invisible hand of accounting standards serves alongside law as a rough equivalent. Such rules pilot executives and accountants toward how and what to manage and measure. But do these buoys—long the handiwork of a priesthood of specialists—reflect the views and needs of modern investors? Shareowners must make judgments on a firm's value and market price based in large part on analysis of financial information released by companies. But current conventions set in cement the great, ill-concealed secret of traditional accounting: rules greatly underrate the financial impact of a company's relationship to employees and society at large.

The gap can result in acute distortion. Former New York City deputy comptroller Jon Lukomnik often cites a vivid illustration. "If Bill Gates were to leave Microsoft and go to Sun Microsystems, you can be sure the stock of Microsoft would go down and Sun's up. Yet Gates is listed nowhere as an asset on Microsoft's books. If anything, he is a liability because of accrued compensation and other rules. So the accounting we use is just plain inadequate to a services and intellectual-capital based economy." Investors resort to educated guesses as an alternative.

No one knows this more than accountants themselves. Their firms are first among the many mainstream bodies scrambling to develop common measures of assets so hard to define that experts officially label them "intangibles." If they elude classification, though, such attributes nonetheless are among the most powerful drivers of modern business success. They include a corporation's management of intellectual property such as brands and innovation, employee skills—often dubbed 'human capital,' its reputation, and its capacity to control environmental risk. Civil society organizations would call most of these social, or stakeholder, relationships. Entrenched accounting standards, by contrast, were developed in the manufacturing-centered era to compute the tangible assets—bricks and mortar—of a firm. As long as measurements fall so short, risks are opaque. Managers and investors alike find themselves unable accurately to price in the bottom line implications of a corporation's social performance.

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[2] The author is a founder of and partner in GovernanceMetrics.

Here again, though, new powers on the ground are re-shaping market architecture. Solutions are emerging from groups never before involved in accounting standards. The Global Reporting Initiative, SA 8000, AccountAbility's AA1000, the SIGMA Project and other models are ahead in recruiting companies to experiment with fresh asset-measuring techniques aligned with new capital interests. Consumer advocates in the US (the Association for Integrity in Accounting) and the Netherlands (SOBI) want a say in how standards evolve. Various corporations around the world are testing in-house methodologies, too. At the end of the day, universal adoption of such formats will hinge on whether civil economy institutions exercise sufficient clout on stock exchanges, standard setters and corporates. It may also depend on the willingness of governments and regulators to intervene in support of more accurate benchmarks of business achievement.

If they succeed, though, proponents will have built a common financial infrastructure that effectively links social responsibility to shareowner value. When companies begin releasing accounts based on and audited against such standards, the financial impact of a firm's social performance will become transparent. Stock prices will begin to reflect more than they can now the ability of a company productively to manage critical stakeholder relationships.

Civil Society Organizations as Market Forces. The success of a civil society rests on the proliferation and clout of non-governmental organizations working within the law for change. So does a civil economy—except that civil society groups must adapt their strategies to suit channels afforded by capital. Many still shun the market, hewing to the conventional Cold War habit of seeking solutions only at the political level. Some champion violent protest or use muscle for corrupt purposes, placing themselves decisively beyond the bounds of a civil economy. But others who understand the latent power of capital peacefully marshaled are paving fresh paths.

Trade unions in certain countries are among them. Through its Office of Investment and Center for Working Capital, the US AFL-CIO federation has honed tactics that convert labor-run pension funds into powerful instruments of shareowner activism. They press fund managers and, through them, corporations, to improve governance as well as employee relations. Australian, Dutch, German and UK union federations are taking a similar course.

Anti-poverty groups, too, have recently recognized advantages of mobilizing capital. In 2001 the London-based War on Want and Traidcraft Exchange issued a handbook guiding pension fund trustees and fund managers on means to push companies for responsible practices. In 2002, environmental advocates joined them en masse in embracing a shareowner agenda. Boston-based CERES launched its "sustainable governance" initiative in an effort to achieve results through shareowner activism. It also published a report making a financial argument for corporate attention to climate change. Along the same lines, the Rose Foundation for Communities and the Environment issued *The Environmental Fiduciary: The Case for Incorporating Environmental Factors into*

Investment Management Policies. Britain's Chartered Institute of Management Accountants published its similar *Environmental Accounting.* The International Finance Corp. (an arm of the World Bank) and the Ethos Institute released *Developing Value: The Business Case for Sustainability in Emerging Markets*. And ASRiA stepped up efforts to promote socially responsible investment in Asia.

Groups such as these can themselves best enhance their legitimacy as players in the civil economy—can earn their own 'license to operate'—by meeting fundamental governance standards they demand of corporations. That, too, is a requirement of the implied constitution of the new capital market. Policies and leaders of non-governmental organizations should be fully accountable to their members, their actions and conflicts of interest transparent, and their means peaceful.

Pressed by their own members and clients, big funds too are acting on the environment. Some steps would have been unthinkable just a couple of years ago. For instance, the UK's National Association of Pension Funds now routinely issues social profiles of all major UK listed companies. And mainstream coalitions in the US and UK each recently formed climate change taskforces calling on corporations to report more completely on harmful emissions.

To reach such ends, funds are finding new ways to collaborate with each other within and across borders. Such efforts are giving rise to a growing population of civil economy groups such as the International Corporate Governance Network, the Canadian Coalition for Good Governance, the Global Institutional Governance Network and the Asian Corporate Governance Association. International alliance building has caught on among corporate directors, too. To improve oversight of managers, they have formed new associations in Eastern Europe, Latin America and elsewhere. Academics are not far behind. Corporate governance centers are being founded nearly every month at universities around the world: So are "virtual centers" such as the European Corporate Governance Institute or India's Academy of Corporate Governance. Research, international conferencing and networking are their top priorities.

Taken together, these fast-moving developments can be seen as knitting together a nascent market-based network of civil economy organizations bound to help shape the new face of enterprise.

Government's Job

In a Darwinian sense, submissive owners, marginal or conflicted monitors, absent civic groups and blinkered accounting standards cannot help but give rise to companies that celebrate shortsighted stock price jumps instead of sustainable growth. Creatures of a flawed economic terrain, many firms by their actions understandably provoke public resentment of globalization.

By contrast, a new species of corporation naturally evolves when owners are energized, monitors are girded with safeguards against conflict, civil society organizations become a constructive market force, and performance yardsticks help managers and investors gauge real drivers of value. This kind of civil economy terrain spawns corporations skilled at cultivating commercial dynamism in a context of accountability and responsibility. For early indications of how this works, just look at the extent to which intense consumer and investor pressure on some of the world’s big multinationals—Royal Dutch/Shell, BP, Nike and Reebok—has convinced them to become vocal, if still perhaps imperfect, apostles of socially responsible management.

Evidence coming in from diverse markets already illustrates the evolution of a virtuous circle. Companies with active, long-term shareowners are ones that introduce more responsive governance and are more likely to produce higher returns, drawing in turn more long-term—and loyal—investors. Such corporations gain access to capital at a lower cost, giving them advantages over rivals. Latest studies showing this effect come from S&P, the Hong Kong-based brokerage CLSA and McKinsey & Co. Accountability in all parties, in short, is surfacing as one of the most effective keys to unlocking sustainable value. It is, in effect, the “invisible hand” of the civil economy.

Still, only a fraction of the world’s listed companies feature what we might identify as hallmarks of the civil economy enterprise: a professional, independent board; a culture of disclosure; and executives skilled at drawing value from management of corporate social responsibility. Is there a role for public policy in speeding progress?

There is—at both national and international levels. Governments are necessary partners in creating conditions for accountable commerce. They are the ultimate guarantors of rules applying to all parties. However, the most effective results come from intervention with a light touch, allowing market forces to do the heavy lifting. Indeed, most of what is needed from government is surgical adjustment of regulation and law.

The beauty of that equation—small public expenditure yielding big results—is that it could be a winning platform for any political leader under pressure to spur both growth and social justice when there is little money in the public till.

At home, governments best capable of stimulating reform are those arising themselves from successful civil societies. They are inherently more stable. And policies grounded in democracy and exposed to public scrutiny inevitably yield wider acceptance and fairer implementation. But once a government embraces the need for action, the agenda for change is long.

Lawmakers can aid the rise of a civil economy by promoting the development of domestic investing institutions: pension funds and shareholder associations. Further, governments can compel such funds to meet fundamental standards of accountability so that savers’ financial clout is exercised rather than disregarded, and aligned solely with the interests of savers. Individuals with money in pension funds should have rights to elect trustees, and gain regular updates on how asset managers vote and act on behalf of savers on corporate issues. Such measures wake up markets by empowering institutional owners and making them responsive to the interests of citizen pensioners.

Domestic policymakers must also ensure that those investors have the tools they need to act as real owners. To a large degree, this means a set of simple rules on disclosure. Every listed company should have to place all financial statements and regulatory filings on the web in a timely fashion. For large corporations with nonresident shareowners, such information should routinely be provided both in the home market language and in English, the dominant tongue of capital. Boards should have to explain how management handles risks related to the workplace and the environment. And they should reveal in detail the ways in which executive remuneration is linked to performance.

Policymakers can spur a race to the top through tested measures such as best-practice company law, tough regulation and impartial prosecution, and codes covering board and disclosure standards. They can permit class action lawsuits, another brake on malignant management. But they can also use less direct means, such as innovative tax incentives, or rules channeling civil service pension fund investments to best-governed firms. Some stock exchanges are already rewarding enterprises boasting star governance with premium rankings or discounts on listing fees. Britain even has a minister in the Department of Trade and Industry charged specifically with the job of finding public sector means to promote corporate social responsibility.

All these actions can be understood as building an architecture and constitution of engaged owners and responsible corporations. But progress can be painfully sluggish where powerful interests resist the prospect of challenge. Nations with robust corporate governance traditions can help. If they have overseas development aid programs, they should reinvent them to nurture indigenous civil economy institutions in struggling markets. The US Center for International Private Enterprise is a worthy model.

At the international level, glimmers of a new paradigm in economic decision-making are rare. But they are the future. Governments continue to call the shots on trade rules, world debt and central banking. Still, doors are opening to the new grass-roots players of modern enterprise. At the United Nations, Secretary General Kofi Annan negotiated with business executives and investors to produce his groundbreaking Global Compact, a set of corporate responsibility principles. The United Nations Environment Programme gave critical assistance to the Global Reporting Initiative, which issues disclosure guidelines on social responsibility. At the Organisation for Economic Co-operation and Development, leaders reached out to businesses, investors and trade unions to craft corporate governance principles. Then it and the World Bank came to unprecedented agreement creating the autonomous Global Corporate Governance Forum, with potent ties to the private sector. The Bank, in particular, now has a mandate to aid market-based institutions in emerging and transition countries—in effect, a civil economy agenda.

These developments signify only the start of a worldwide transformation of postwar economic life reflecting the profound democratization of capital power. After all, “the proper governance of companies will become as crucial to the world economy as the proper governing of countries,” observes World Bank president James Wolfensohn. But corporate excesses now so emblematic of globalization stir urgent dangers of public backlash. If unchannelled, such reaction could derail change rather than speed it. That is why public and private sector policymakers must understand that the prudent path to a new worldwide 'constitution of the marketplace' lies today in speeding the rise of a civil economy. In it, institutions promoting the fusion of accountability and commerce can ensure that globalization truly fulfills its promise of spreading sustainable prosperity.

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