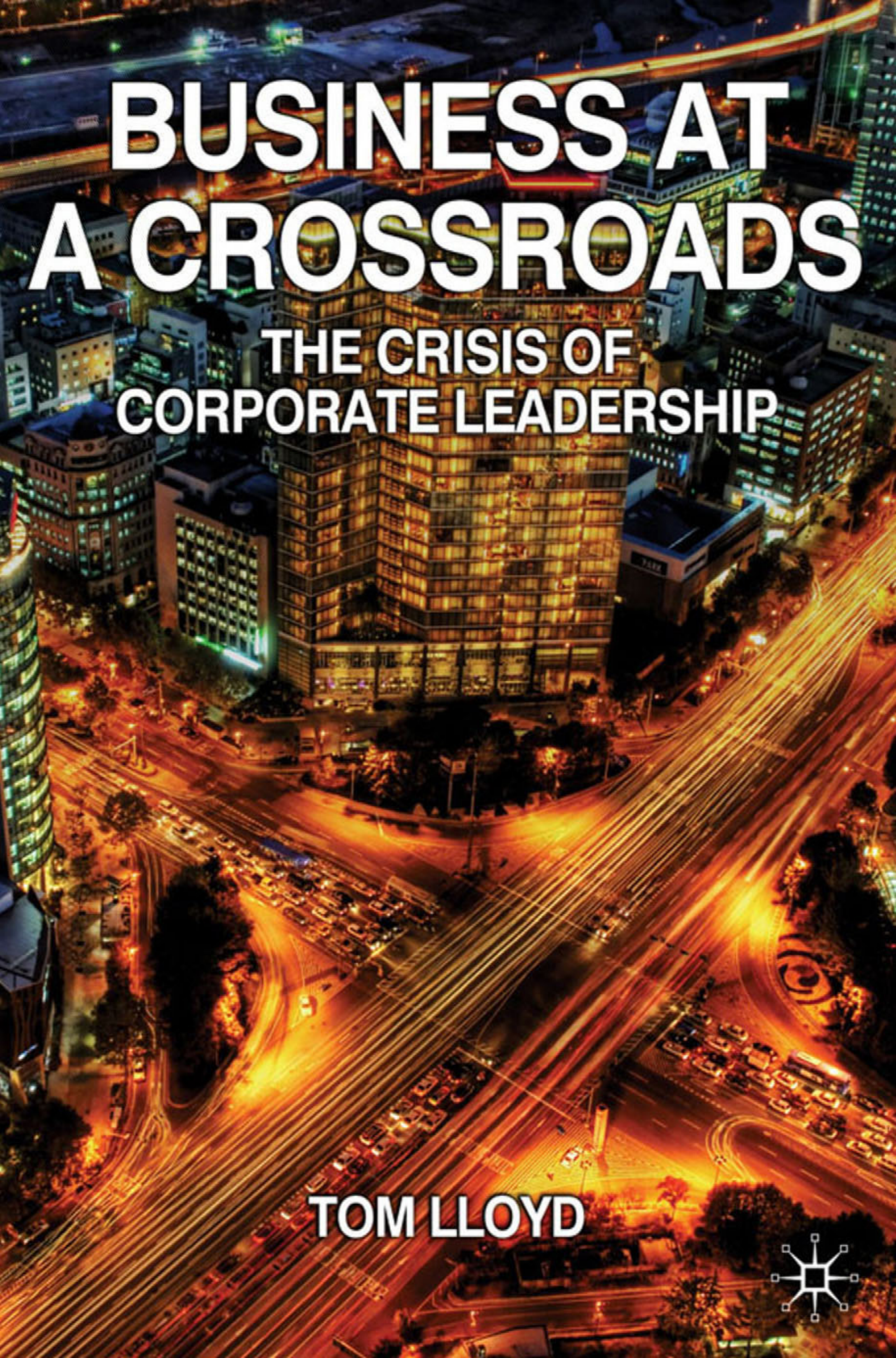
BUSINESS AT A CROSSROADS

THE CRISIS OF CORPORATE LEADERSHIP

TOM LLOYD



Business at a Crossroads

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Tom Lloyd

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This book is dedicated to the memories of my mother Maggie, my sister Judy, and two great friends, Peter Bielby and Ray Heath

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Introduction

The evolution of the liberal capitalist system ground to a halt in 2007–08. The default of the apocryphal subprime mortgage borrower in America's mid-west, a mere flutter of butterfly wings, caused a hurricane of fear to rage through the securitized debt markets and sent the world's banking system into cardiac arrest.

With the help of blood transfusions from central banks, the system regained a semblance of life, but emerged from the trauma a pale shadow of its former self. The hunger for ever riskier lending was transformed into extreme risk aversion. Banks, fearing their peers were even more exposed than themselves to the subprime securities market, stopped lending to each other and lenders dependent on the interbank market collapsed.

When the troubles spread to Main Street a bonfire of all Wall Street's vanities engulfed "the Masters of the Universe," as novelist Tom Wolfe had dubbed investment bankers and securities dealers at the time of a less dramatic crash two decades earlier. What were they thinking? That "securitizing" loans to people on welfare made them less risky? That making a market in risk and moving it about would reduce its virulence? That the magic wand of economic growth would transform sows' ears of subprime debt into prime silk purses?

In the firestorm of recrimination and accusation that followed the crash, the trust ordinary people had in the powers that be – those who had been running the liberal capitalist system, company chief executive officers (CEOs) and their Wall Street allies – and their tolerance of their astronomical pay packets, were consumed.

The system was broken. Its fragility was exposed. There was a flaw in the complicated array of risk management devices and securities those erstwhile masters of the universe had designed to juggle the gravely mis-measured risks of their lending binge.

Perhaps there was a flaw in liberal capitalism itself.

It was up to governments and central banks, which were held partly to blame for what, with hindsight, was seen as their reckless deregulation of financial markets before the crash, to deliver first aid. It is up to us, the ultimate architects of political-economic systems, to decide the kind of society we want to live in, and the kinds of organization we want to work for.

A vote, whether cast with hands or feet, is no small thing, and at a time like the present, when long-held beliefs and previously unquestioned assumptions can no longer be taken for granted, a vote becomes a very large thing. In choosing political parties, by ticking boxes, and choosing the kinds of organization we work for, by walking away from some and toward others, we can reshape our society and its institutions.

Let us choose reform and restoration. The alternative is too awful to contemplate. I fear Yeats's *Second Coming*; the second coming of socialism. The return, to the political debate, of Marx's "blank and pitiless" slogan: "From each according to his ability, to each according to his need."

It would be a rational choice in many ways. The system that failed was manifestly unfair. It was producing gross and rapidly growing inequalities. Ordinary people were already bemused and angered by the huge sums paid to hedge fund managers, investment bankers and CEOs before the crash. They were incensed by the enormous "golden parachutes" paid to the ex-CEOs whose strategies had contributed to the meltdown. They became apoplectic when, *faute de mieux*, their money had to be used to rescue the banks that had precipitated the crisis.

The financial crisis also exposed a profoundly unfair asymmetry in the system. In a rising market, bank lending magnifies gains which enrich a few hedge fund managers, investment bankers and top level executives. But in a falling market, it magnifies losses which are carried by everyone when banks are bailed out by the taxpayer. In this way, boom and bust act like an inequality ratchet. Gains during the boom are captured by the privileged few, losses during the bust are paid for by everyone and, cycle after cycle, inequality grows.

For voters made aware by the bailout that they have been played as mugs in a classic "heads I win, tails you lose" game, it would be folly to allow the game to continue, and rational to substitute neo-socialism for the liberal capitalism that had, supposedly, led to the unfairness.

Rational, but not reasonable.

Something must clearly be done about this unfairness, but to blame liberal capitalism for the inequality and financial crisis, and to vote in a socialist government would be to throw the baby out with the bathwater; to shut Pandora's box before hope emerges. Liberal capitalism has proved its worth. Few now dispute that free markets protected by vigilant antitrust and other forms of regulation are the best system for a society that places a high value on economic well-being.

Vigilant regulation is vital, because there are worms at the cores of free markets. Sir Karl Popper's "paradox of democracy" was that when democracy is too free, tyranny can emerge. When markets are too free, monopolies, inequality and financial instability can and do emerge.

Political, economic, biological and other complex systems all have fundamental flaws of this kind; seeds of their own destruction, in subsystems, tendencies and propensities, which, like cancers, can grow out of control and suborn, take over or otherwise jeopardize the survival of their host systems. That's why liberal democracies need constitutions and markets need regulation.

Recent events and developments suggest liberal capitalism harbors two dangerous seeds of self-destruction; growing inequality, which undermines the political consensus that sustains the system, and a tendency for markets to spiral out of control. The economist, John Maynard Keynes, suggested that economic activity was partly driven by alternating waves of irrational optimism and pessimism. Some 70 years before the 2007 subprime crisis Keynes said, in *The General Theory of Employment, Interest and Money*, most of our decisions "to do something positive … can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities." Some suggest it's these animal spirits, their effects magnified by positive feedback from self-fulfilling prophesies, that drive business cycles.

It's up to us to ensure these seeds of self-destruction in liberal capitalism are brought under control.

My prescription is *reculer pour mieux sauter*; to step back to jump forward more strongly. We need to turn liberal capitalism's clock back to a time before its seeds of self-destruction began to take over.

Evolution in nature sometimes works this way in a process known as "neoteny" ("holding youth"). We are the creatures of neoteny. Our rounded, bulbous cranium containing our large brain resembles that of a foetal ape. Subsequent ape brain growth is slower than ours, so the cranial vault is smaller and lower in an adult. We acquired our large brains by retaining rapid foetal growth rates.

The human face – distinguished from the faces of other primates by its straight profile, small jaws and teeth, and weak brow ridges – resembles the face of a juvenile ape. The resemblance fades as the ape's jaw grows, relative to the rest of the skull, to produce the adult ape's muzzle. The *foramen magnum*, the hole in the mammalian skull from which the spinal cord issues, is underneath our skull, pointing downwards, as in the embryos of other mammals. This means we look forwards, when we stand upright. As other mammals mature, the *foramen magnum* rotates and ends up pointing backwards, so that the animal looks forwards when standing on all fours.

The Microsoft Windows operating system incorporates a *reculer pour mieux sauter* option. If your computer keeps crashing, or begins to run agonizingly slowly, because it has acquired viruses, worms or other internet pathogens, System Restore allows you to restore the machine to a previous known working state. Files and data, such as word-processing documents, spreadsheets, music and images, remain intact, but the operating system itself reverts to its state at an earlier time, before things began to go wrong.

We must do a System Restore on liberal capitalism.

Something of the kind has already occurred in the new regulations for banks and capital markets following the 2008 financial crisis. In a sense, they have restored liberal capitalism's financial subsystem to its mid-1980s state, before the deregulation and subsequent globalization of the financial services industry.

This book advocates the reformation of another creature of liberal capitalism, the large, limited liability joint stock company, some of the features, practices and appetites of which I believe lie at the heart of liberal capitalism's malaise.

In their new "global" guise these institutions appear to exemplify liberal capitalism. They are the overwhelmingly dominant business organizations, and most of us are directly or indirectly employed by them. They seem to be integral to liberal capitalism, or at any rate capitalism. The system seems inconceivable without them.

So prominent and powerful are they that it is easy to forget their relatively recent origins. The company as we know it, only assumed its modern form in the mid-19th century and remained a minor player in business until the early 20th century. But since then, this form of enterprise, cobbled together with a structure borrowed from the military, practices and habits inherited from mercantilist trading companies, and hungers derived from the entrepreneurial businesses and partnerships that drove the Industrial Revolution, has been astonishingly successful. The modern world is in many respects its creature.

But it has begun to show clear signs of decadence.

Enron, WorldCom, Tyco and Parmalat are a few of the names that had tainted the reputation of "big business" with a whiff of fraud and corruption long before the big crash. These scandals led to the Sarbanes-Oxley Act in the U.S., and similar laws and codes of practice elsewhere.

That such regulations were deemed necessary in nations wedded to laissez-faire economics reflected a concern that, when left to their own devices, big companies tend to behave badly and it was, therefore, necessary to curtail their liberty.

The generally more critical view of business has also been evident recently in the accusations by governments, fiscal authorities and commentators that companies that engage in aggressive tax planning (tax avoidance, the opportunities for which have been increased by globalization and tax competition between national governments for foreign investment) are behaving unethically, and not paying their dues to the societies in which they operate.

But much the clearest and, in my view, the most worrying sign that the large, publicly listed, limited liability, joint stock company has entered a decadent stage where its behaviour is diverging from commonly accepted standards, is the executive pay explosion. Let us be clear about this issue from the outset. There is no remotely conceivable justification, economic or otherwise, for the CEOs of our largest companies to be paid several hundred times the average pay of their employees.

I imagine readers gasping in disbelief. Surely this is a typing error? But no. At the top of the bull market in 2000, the CEOs of the 500 largest U.S. companies were paid ("earned" is entirely the wrong word) on average over $500,000 for every $1,000 paid on average to the rest of their employees. The subsequent market crash (a minor blip, compared to what was to come later), and new reporting rules requiring companies to account for stock options as expenses, led to a brief reduction in the multiple subsequently, but the average multiple for Fortune 500 companies was 350 in 2005, and rising.

There's a furtiveness about executive pay. Like a spider caught in the light, it freezes and sometimes even retreats, when it becomes a focus of attention, but creeps up again when no one is looking. It froze and retreated after the 2008 crash, in response to public outrage at the huge severance packages and pensions paid to former CEOs of banks who had bet the farm on subprime debt.

CEOs are not stupid. They can't possibly believe they are actually worth what they're paid. They know there's no link between CEO pay and corporate performance. So why do they demand such enormous pay packages and, more importantly, why do their shareholders accede to their demands? These questions lead directly to the rottenness at the core of the modern corporation. But greed isn't the answer. To explain the CEO pay explosion as a consequence of insatiable human greed is to miss the point entirely.

CEOs aren't abnormally greedy. They simply accept the good fortune that has brought them to a place where huge rewards are there for the taking, ignore protests in the popular press about troughing and fat cats and try to ensure that their pay remains competitive. As one German CEO, relatively lowly paid by Anglo-Saxon standards, is said to have put it: "I know I am overpaid, but the benchmarks say I'm not overpaid enough."

It is an institutional greed; a product, not of human avarice, but of the way hierarchical corporate organizations concentrate power in the hands of individuals and create a "CEO class" isolated from market disciplines, where remuneration is decoupled from work and economic value added, and CEO pay packets chase each other upwards in a never-ending spiral.

Let us be clear about another thing from the outset. Pay and power are inextricably linked. It would make no sense for shareholders to pay their CEOs huge amounts of money if they didn't also assign to them huge amounts of power. Only omnipotence can justify modern CEO rewards and omnipotent CEOs can't pass the buck when things go wrong.

The consequent emergence of what are in modern times unprecedented inequalities of power, income and wealth, marks the beginning of a new and alarming chapter in the evolution of liberal capitalism. I will argue that, fortunately for liberal capitalism, the explosion in executive pay is not a natural outcome of the system. It is an aberration that can be corrected. It must be corrected, because it is the Achilles heel of modern capitalism. It is so obviously and so offensively unfair that, if it continues, the sense of fairness and justice that sustains the liberal democratic consensus will be undermined.

Growing inequalities within liberal capitalist societies and their business organizations undermine not only the general consensus on which these societies rest, but also the countless contracts of employment and association that comprise that consensus.

Partly because of the executive pay explosion, modern companies are seen by their employees and prospective employees as profoundly unfair organizations that do not recognize or reward ability and diligence proportionately. Why this should be so is something of a puzzle. Institutions that compete with each other in a free market should realize the vital importance of paying fair rates for goods and services rendered, and the market itself should penalize those that don't. But disparities in pay – between men and women, ethnic groups and, most conspicuously, between middle and senior managers and "C-level" executives (CEO, CFO, COO, and so on) – persist. Whatever the reasons for them, these huge disparities in income are seen as unfair and hang like dark clouds over company cultures, breeding resentment in those who have to get by on a tiny fraction of their leaders' incomes.

It is not the fact of differences in pay that is controversial; it is the extravagance. It is simply impossible for reasonable people to believe that their CEOs, several of whom are sacked with multi-million-dollar severance packages each year for incompetence and who, as a breed, are notorious for destroying shareholder value by paying too much for acquisitions and – in their pursuit of targets linked to their incentive plans – for taking too many risks, could be worth such huge rewards.

The second problem, related to the first, that people have with large companies, is the deterioration in the so-called "work–life balance." Working for large, complex organizations has always been demeaning, since Henry Ford turned his employees into cogs in a machine. More recently it has also become intolerably demanding. In today's intensely competitive business world CEOs have to crack the whip harder and harder to get their numbers to the point where their incentive plans kick in. The result is that it is becoming difficult, if not impossible, for ambitious managers to maintain a full and fulfilling family and social life.

It is here, in the unfairness of large companies and the excessive demands they make on employees, that the System Restore, *reculer pour mieux sauter* possibility lies. People voting with their feet, moving from one kind of organization to another, is the engine of the evolution of the corporate form. For lack of anything better, we have put up with the unfair and demanding organizations most of us work for, but we are unlikely to do so for much longer. People, particularly those exceptionally able people large companies fight tooth and nail with each other to employ in the so-called "war for talent," are now realizing that recent technological, economic and social changes give them more options.

Nowadays, they can leave organizations in which they feel uncomfortable with less fear of becoming destitute and they can form, join or become associated with smaller, looser organizations that offer them work and types of association that suit them better.

Once their economic needs have been met people will seek the kinds of work and types of association that appear, to them, most likely to satisfy their emotional needs and particularly their hunger for self-respect. I believe it is this human hunger for self-respect, rather than globalization or technological change, that is driving corporate evolution. Like natural forms, corporate forms co-evolve with the environment in which they compete for resources. Now that able, hard-working people, the most important business resources, realize they have choices, they will leave organizations that deny them self-respect.

This book explains why capitalism's main economic agent, the large CEO-led, limited liability joint stock company, is in dire need of fundamental reform and suggests some steps companies could take to improve their adaptation to today's environment. It focuses on the U.S. and the U.K., because it is in these countries that the problems are most acute, and the decadence of companies is most advanced.

There are three protagonists in my story. The first is the company that wants to hire able people who respect themselves, because it knows they are more self-confident and creative than wage slaves. The second is the individual who, as a voter, wants a society that is fair as well as free and, as a worker, yearns for a career that is fulfilling and rewarding without demanding so much commitment that she or he feels inadequate as a partner, parent, friend and human being. The third is less easy to describe. It is the modern company's as yet inchoate nemesis – the new breed of enterprise that will challenge and possibly replace the company if it fails to reform itself.

The first step in a System Restore process is to choose an earlier date to which to return the system or institution. This is no easy task because, although the problems themselves (the unfairness and excessive demands) are clear enough, their causes are shrouded in the mists of the past. We must go right back to the origins of the institution itself to understand what corporations are and why and in what ways they became decadent.

There is no mystery about why trade and business developed. It was because there are synergies in exchanges of goods and services, and economies in specialization. Business organizations were developed to conduct business and trade, because there are economies in the coordination of business activities and synergies in cooperation between specialists.

But there is no ideal business form or model of association. Forms and types of association emerge in response to new challenges and will fall into disuse when changes in their environment make them less "fit"; when their initial virtues become, or are replaced by, vices. Each form has what evolutionists call a unique "environment of evolutionary adaptedness" (EEA) and tends to become less fit as its current environment diverges from its EEA.

Today's dominant form of business organization emerged in response to the environment of the late 19th century, so it's no surprise it has run into trouble in the environment of the early 21st century. Much has changed over the past 150 years. Markets have become more efficient, a global economy has emerged and new technologies have changed the nature and intensity of competition, and created space for new enterprise experiments and business models.

Most important, the attitudes, outlooks, aspirations and emotional needs of able individuals have been changed profoundly in the past two decades or so by important social and economic developments. These include the unilateral repudiation by most employers of the old "loyalty for security" psychological contract (keep your nose clean and close to the grindstone, and you have a job for life); the re-emergence of the market rather than the organization as the mechanism for valuing human worth and allocating human resources; the opportunities for self-employment created by the internet and the disaggregation of business through outsourcing and other kinds of association; and more recently, the sea change in the perceived cost–benefit profiles of employment, versus self-employment caused by the recession. (Recessions always eject large numbers of people from companies and not all of them return when growth resumes.)

The importance of these changes lies not so much in themselves, as in the options they offer able people to satisfy their hunger for self-respect. Just as slaves and serfs had to resign themselves to their status when there was no prospect of freedom, so wage slaves raised no objections to their economic serfdom when there was no obvious alternative. People are beginning to realize that there is an alternative now. Economic serfdom has become voluntary.

The human hunger for self-respect has led to the gradual diffusion throughout the world of a system of government we call liberal democracy. It has been a slow process and, even now, liberal democracy is not universal. But the trend is clear and it seems for the most part to be irreversible. Self-respect is a "primary good," as John Rawls[1] called it, and history suggests that, in the political arena at any rate, it's maximized for the mass of ordinary people within a liberal democracy.

This same hunger for self-respect requires changes in the forms of organization and the types of association in which, and with which, people will come together in future to combine their talents and abilities in concerted efforts to create wealth.

This book has two parts. The first six chapters focus on what ails big business. The final four chapters focus on what can be done to reform it.

Part I, "What ails big business," begins in **Chapter 1** with an invitation to readers to redesign work; to ask themselves how, in an ideal world, they think work should be managed or organized and how, in an ideal world, they think that the rewards for work ought to be distributed.

Armed with the model extracted from this thought experiment of the working arrangements most people want, I shall explain, in **Chapter 2**, why they have so far been denied such arrangements. My approach is