

# **CORPORATE RESPONSIBILITY, REGULATION AND PARTNERED OR COLLABORATIVE GOVERNANCE:**

## **AN INTRODUCTION**

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The timing of this seminar could not be more timely. The collapse of financial markets has reinforced an existing trend towards regulating market economies. With the coming of privatisation as policy in the 1980s, governments moved away from direct state ownership of industries and services to private ownership with state regulation. A landmark in the UK in this process was the privatisation of British Telecom in November 1984, the creation of a dedicated regulatory office for the industry, the Office of Telecommunications (OFTEL) and the introduction of a price cap regime to control prices over time and, in effect, profitability. What privatisation did not do was “roll back the frontiers of the state”. Rather, it redefined the frontier.

Today the frontier is expanding in terms of regulation, in part accelerated by European Union directives. We now live in the “regulatory state”, where few areas of business are free from some kind of regulation. Typically, firms are regulated in terms of:

- Outputs – e.g. in pharmaceuticals, energy, telecommunications
- Employment – employment laws.
- Location – planning laws.
- Working practices – health and safety laws.
- Taxation – tax law and practice.
- Accounting – accounting standards (regulated at the professional level but with government taking a keen interest).
- Capital raising – stock market rules and rules on new share issues.

- Industrial restructuring – competition law, takeover codes.
- Corporate governance – Companies Act.
- Environment – emissions etc.

This regulation is not only pervasive, it is highly costly, both in terms of the direct costs of administering regulation and the compliance costs placed on business. In 2004 the British Chambers of Commerce quantified the total costs of regulation on business, from 1998 to July 2002, at £20.6bn. By June 2003 this figure had risen to £30bn.<sup>1</sup> Sir Digby Jones, then Director General of the CBI, complained in 2005 that 95% of business leaders felt that the time they spend dealing with regulation had increased over the previous five years; while a survey of offshoring work in 2004 by CBI/MORI concluded that regulation in the UK was an important factor in companies' decisions to relocate abroad.<sup>2</sup>

Starting with the Better Regulation Taskforce in the Cabinet Office and now in the form of the Better Regulation Executive (BRE), anchored in the Department for Business Enterprise and Regulatory Reform, steps have been taken to control the regulatory state, but arguably with, at best, mixed results. The BRE has overall responsibility for the government's commitment to:

- Regulate only where necessary.
- Set exacting targets for reducing the costs of administering regulations.
- Rationalise the inspection and enforcement arrangements for both business and the public sector.<sup>3</sup>

Equally, there has been a raft of business and academic publications in recent years, all aimed at simplifying, restructuring and reforming the regulatory state to reduce costs and improve effectiveness. However, it is not obvious that this effort has produced really meaningful results.

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<sup>1</sup> BCC (2003) *Do Regulators Play by the Rules? An Audit of UK Regulatory Impact Assessments*, London: British Chambers of Commerce; BCC (2004) *Red Tape Costs Spiral to £30bn.*, Press Release 8 March, London: British Chambers of Commerce.

<sup>2</sup> Jones, Sir Digby (2005) "Tell us Which Red Tape Should Go", *Business Voice*, May, p.3; Co L (2004) "Why We Stand to Gain", *Business Voice*, March, pp.1-11.

<sup>3</sup> Parker, D. (2006) *Regulatory Impact Assessment: A False Dawn?* Bath: Centre for the study of Regulated Industries Occasional Lecture 15, University of Bath School of Management.

## Why Regulate?

Adam Smith wrote in 1776 in *The Wealth of Nations*:

“People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices...”<sup>4</sup>

State regulation is predicated on the belief that markets fail from time to time, and government intervention is needed to reverse or at least ameliorate the failure. Competition policy is a good example of such state intervention, intended to address precisely the point Adam Smith was making about conspiracies against the public. Restrictive practices law, monopoly law and the law on mergers are there to tackle the “conspiracy”.

Markets may “fail” for other reasons too relating to externalities, such as environmental costs, income and wealth distribution (market outcomes may not be deemed “fair”), incomplete information (producers and consumers may not be well informed to make rational decisions) and public and merit goods (goods and services for which it is difficult to achieve market payments to sustain adequate consumption). “Market failure” clearly does exist, but so, of course, does “state failure”.<sup>5</sup> The fact that markets may not allocate resources perfectly (however defined) does not necessarily legitimise the case for state intervention. The costs and distortions of state action can greatly outweigh any benefits from state involvement; as numerous episodes in post-war economic policy illustrate.<sup>6</sup> As Adam Smith warned in 1776:

“The proposal of any new law or regulation of commerce... ought always to be listened to with great precaution, and ought never to be adopted till after having been long and carefully examined, not only with the most scrupulous, but with the most suspicious attention. It comes from an order of men, whose interest is

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<sup>4</sup> This and other quotations from Smith’s work can be found in Butler, E. (2007) *Adam Smith – a Primer*, London: Institute of Economic Affairs.

<sup>5</sup> Blundell, J. and Robinson, C. (2000) *Regulation without the State: the Debate Continues*, London: Institute of Economic Affairs.

<sup>6</sup> Myddelton, D.R. (2007) *They Meant Well, Government Project Disasters*, London: Institute of Economic Affairs.

never exactly the same with that of the public, who have generally an interest to deceive and even oppress the public, and who accordingly have, upon many occasions, both deceived and oppressed it.”

Smith’s prophetic words are never more apt than at the present time. The crash of international banking is leading to a whole new cacophony of demands for more state regulation and even state ownership. For example, recently both Nicolas Sarkozy in France and Angela Merkel in Germany appeared to agree on what Sarkozy calls the need for “reform of capitalism”. Sarkozy and Merkel seem to have in mind heavier regulation of banking, tax havens, hedge funds, rating agencies and short selling practices in the City. Schadenfreude exists in much of continental Europe over what is now labelled the crisis of the “AngloSaxon model”.<sup>7</sup> The model of privatisation and market liberalisation, the dominant economic paradigm in most parts of the world since the 1970s, is now undoubtedly under concerted attack. A number of commentators have suggested that economic policy is at a watershed. Consistent with this position is an opening comment in a recent paper published in the journal of the Royal Society of Arts:

“The competitive market economy, our present development model, has shown a continuous ability to be creative while at the same time there has been a blurring of its link with the global common goods and a significant loss of our capacity to regulate it. Without an in-depth transformation, this hitherto successful model runs the risk of becoming unsustainable and of losing its moral and political legitimacy.”

Globalisation and the “green agenda”, combined with the current state of economic gloom, are leading to demands for a new era in economic policy. But does the economic watershed necessarily imply yet bigger government? Or is there a credible alternative?

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<sup>7</sup> “Europe needs to focus on crisis, not regulation”, *The Daily Telegraph*, 14 February 2009, p.38.

## Corporate Governance and the Regulatory State

Less well known than Adam Smith's *The Wealth of Nations* is the volume that he published 17 years earlier, in 1759, called *The Theory of Moral Sentiments*. Smith saw both volumes as complementary, not as alternatives.

*The Wealth of Nations* deals with economic matters, while *The Theory of Moral Sentiments* deals with appropriate behaviour in society. Smith studied moral philosophy at the Universities of Glasgow and Oxford and became Professor of Moral Philosophy at Glasgow. He appreciated, although some of his modern disciples appear not to do so, that the market economy cannot function effectively and efficiently without appropriate modes of behaviour. More specifically, moral behaviour and actions are a prerequisite for a successful market economy.

Smith believed that as individuals we look after ourselves, our own interest (*homo economicus*), but as social creatures we are endowed also with an innate sympathy for the plight of others. We share in the pain and pleasure of other people with whom we live and work. The consequence is that society has a code of behavioural norms or what we can call "morality", which has evolved over time. Punishments and rewards, and the judicial system and Acts of Parliament, reflect and help to maintain that morality. While the resulting moral code is more than a matter of the individual's calculus of personal cost and benefit. In effect, in Smith's *Theory of Moral Sentiments*, the message is that without morality, society fractures and economic progress is thrown sharply into reverse. In Smith's writings, the "invisible hand" wears a "moral glove".

Entrepreneurs create wealth and in doing so useful goods and services that enhance well-being in society. But the result, personal wealth, is a by-product not the *raison d'être* of the human condition. The truly virtuous person, Smith concludes, is someone possessing prudence, justice and beneficence. Prudence moderates individual excess. Justice limits the harm to others. Beneficence prompts the promotion of the happiness of others. In other words, Smith is arguing that the market economy is sustainable only if people limit the pursuit of pure self interest. The conclusion seems particularly apt today: the pursuit of wealth for its own sake is not

necessarily consistent with morality. This is a prophetic conclusion, given the current revelations about banker behaviour in the City in recent years. The market economy, in modern parlance, can only thrive with *corporate responsibility*. Smith’s conclusions suggest that extending state regulation to tackle “banking excesses” would, at best, tackle the symptoms, but not the root causes of our deep malaise.

Figure 1 summarises two pathways to the same result, improved social welfare. The first is predicated on “market failure” and a lack of trust in business behaviour. Regulation is there to restrain and redirect business behaviour in ways deemed, by government, to be more conducive to public welfare. This route lies at the heart of economic policy in the UK since the 1970s. The second pathway draws inspiration from recent writings on Corporate (Social) Responsibility but has roots in the *Theory of Moral Sentiments*. This route is predicated on achieving appropriate business behaviour consistent with public welfare and without the need for heavy state regulation. In reality, it is unlikely that all state regulation could be removed entirely. Nevertheless, the Corporate Responsibility agenda may offer the means, perhaps the only means, to stem the tide of discontent with business behaviour that feeds the state-regulation juggernaut. Good corporate citizenship must be more than the “smug form of public relations” that populates company annual reports today.<sup>8</sup>

(Figure 1 here.)

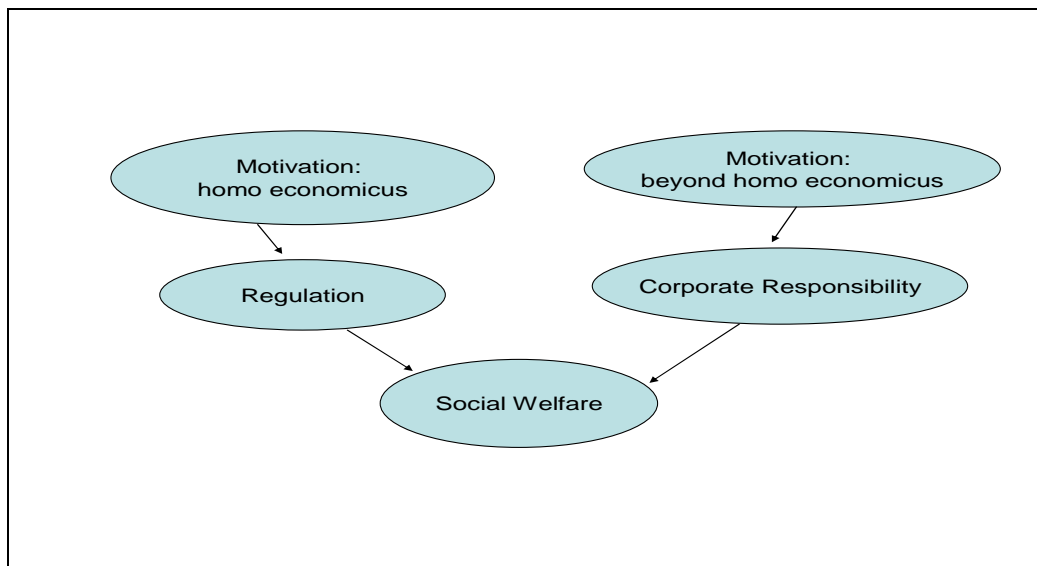


Figure 1

<sup>8</sup> “How good should your business be?” *The Economist*, 19 January 2008, p.12.

## The Corporate Responsibility Agenda

Corporate Responsibility (CR) involves businesses voluntarily adopting higher standards of performance than is required by law. It has been defined by the EU Commission as: “a concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a *voluntary* basis.” (emphasis added).

More fundamentally, a responsible business is “*one that has built-in to its purpose and strategy a commitment to deliver sustainable value to society at large, as well as to shareholders, and has open and transparent business practices that are based on ethical values and respect for employees, communities, and the environment.*”<sup>9</sup>

CR has grown around the world for a variety of reasons. These include the increased expectations of employees, consumers, governments, non-governmental organisations (NGOs); increased global media scrutiny of business; and greater business power as a result of privatisation, liberalisation and consequent globalisation. Critics of CR from both a right-wing, classical free-market tradition and from a left-wing, market-interventionist perspective have all criticised CR – inter alia for the fact that the leading corporate citizens (especially if they are powerful multinationals) effectively impose their environmental and social standards on other businesses and have a vested interest in extending the costs of implementing the obligations which they have themselves voluntarily assumed on to their competitors. The former OECD Chief Economist, David Henderson, criticises the “misguided virtue” of CR,<sup>10</sup> also arguing that as well as distorting markets, it creates additional non-tariff barriers to trade and may slow the development of emerging economies by forcing higher standards than the stage of economic development allows. Conversely, the former Clinton Administration Secretary of Labor, Professor Robert Reich, has argued in his latest book *Super-capitalism*, that CR distracts opinion-formers from the proper task of influencing governments to act, and may dilute pressures for changing public policy.<sup>11</sup>

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<sup>9</sup> Grayson, David (2007).

<sup>10</sup> Henderson, David (2001) *Misguided Virtue*, London: Institute of Economic Affairs.

<sup>11</sup> Reich, Robert (2007) *Supercapitalism*.

A more benign interpretation is that CR offers a route to new mechanisms for creating smart standards (i.e. better influenced by technological and market-place standards because the voluntary early adopters provide their practical experience to regulators of how to achieve their policy goals). Or it is a voluntary alternative to formal regulation, if there is enough industry/sectoral support for voluntary standards, so as to obviate the need for formal regulation.

The report, *Tomorrow's Global Company: Challenges and Choices*,<sup>12</sup> suggests that one key role now for Global Companies is setting standards. Standards may be at the level of the individual firm; they may also be voluntary, industry-wide agreements or the fore-runner of mandatory national or international standards. This may be particularly true in a global context, where many multinationals have operations in parts of the world, which have what the World Economic Forum has described as “weak” or even “bad” governance (or where there are weak/ non-existent international standards).

Prof Atle Midttun from the Norwegian School of Management has suggested that individual companies adopting CR may be self-regulators and where a group of companies together adopt higher standards of ethical, environmental and / or social performance, they are co-regulating.<sup>13</sup> Midttun further suggests that putting some kind of democratic framework around these voluntary company commitments may also be one of the ways of addressing some of the current criticisms of CR as being either undemocratic or anti-competitive.

The Extractive Industries Transparency Initiative is a good example of this process. The EITI began after BP tried and failed to publicise the royalty payments it was making to the Angolan Government. With the help of the British Government and subsequently of several other governments, BP has persuaded other energy companies to increase transparency and publish what they pay. Several governments have now endorsed and put their weight behind the EITI. Similarly, by helping to fund the secretariat of the Carbon Disclosure Project, governments are endorsing this voluntary

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<sup>12</sup> “Tomorrow's Global Company: Challenges and Choices” (2007), London: Centre for Tomorrow's Company.

<sup>13</sup> EABIS (2007) Speeches Annual Colloquium , Barcelona.

initiative to get the world's largest companies to state whether they have carbon reduction strategies in place. Individual governments could have passed laws requiring companies in their jurisdictions to answer questions about carbon reduction strategies. In practice, the Carbon Disclosure Project – endorsed by more than 300 of the world's largest institutional investors, representing more than \$41 trillion of funds – probably has more sway than most governments.<sup>14</sup>

Dr Simon Zadek: CEO of the think-tank and campaigning organisation:

Accountability has argued that new forms of “partnered governance” between governments, businesses and ngos may be emerging.<sup>15</sup> The Davos World Economic Forum (WEF) has also recently looked at the role of businesses in improving governance, including the business case arguments for doing so.<sup>16</sup> WEF identified three sets of circumstances:

- weak governance
- bad governance
- weak / non-existent, international frameworks.

1) **Bad Governance** is characterized by deep flaws in the domestic enabling environment, such as corrupt institutions, ineffective or discriminatory laws or regulations, the presence of civil conflict or other security threats, gross human rights violations, etc.

2) **Weak governance** is characterized by insufficient institutional capacity and/or political will resulting in governmental failure to implement or enforce domestic laws or international obligations, deliver basic public goods and systems, or plan for and respond adequately to natural disasters, health pandemics and humanitarian crises.

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<sup>14</sup> Marsden, C and Grayson, D (2007) *The Business of Business is...? Unpicking the Corporate Responsibility Debate*, Doughty Centre for Corporate Responsibility.

<sup>15</sup> Zadek, Simon (2005) *The Logic of Collaborative Governance – Corporate Responsibility, Accountability and the Social Contract*, CSR Initiative of Kennedy School of Government, Harvard: Working Paper No 3.

<sup>16</sup> World Economic Forum (2008), *Partnering to Strengthen Public Governance – The Leadership Challenge for CEOs and Boards 2008*.

3) **Underdeveloped global governance** is characterized by either a lack of rules or institutional capacity at the multilateral or global level necessary to create a level playing field or greater certainty regarding issues that have an important bearing on commercial and investment decisions across national borders (e.g. labour, environment, product safety or technical standards, etc.).

The business leaders who signed the Davos report argue that:

*“Each of these types of governance deficits interferes to one degree or another with economic development and social and environmental progress.”*

They go on to list a range of examples of where business has already formed a variety of initiatives with governments, international institutions, NGOs and other businesses, in order to address instances of bad or weak governance, or underdeveloped global governance.

### **Future Pressures**

The current, global financial and economic crisis is prompting more demands for improved, international regulation. The British Prime Minister, for example, has proposed ad hoc meetings of a global “college of supervisors” of existing regulators better to co-ordinate the oversight of financial institutions.<sup>17</sup> The Italian Finance Minister wants the G7 to establish a worldwide “legal standard” of rules governing the future of globalisation. The Italian proposals involve building on existing OECD conventions to create a legal standard: “The proposed OECD instruments for the legal standard include an anti-bribery convention, principles on corporate governance including state-owned enterprises, guidelines on multinational enterprises, standards of transparency and co-operation on tax, principles on disclosure of financial information.”<sup>18</sup>

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<sup>17</sup> Financial Times (2009), February 10<sup>th</sup>.

<sup>18</sup> Dinmore, G (2009) “Italy urges ‘legal standard’ on finance”, *Financial Times*, 16<sup>th</sup> January

In the UK, the opposition Conservative Party has proposed a domestic version of partnered or collaborative governance with “Responsibility deals”, involving government, companies and other stakeholders.<sup>19</sup> The former CEO of ASDA, Archie Norman, is chairing a taskforce looking at how such a responsibility deal might operate in the British retail sector to reduce waste. At the EU level, an umbrella organisation representing a range of NGOs and Civil Society interests called the European Coalition for Corporate Justice, is pressing for more corporate accountability and transparency, including mandatory reporting of companies environmental and social impacts; legal responsibility for EU headquarted companies in EU courts for environmental and human rights abuses committed anywhere in the world; and a duty of responsibility for their global supply chain.<sup>20</sup>

On the global level, one likely area for partnered or collaborative governance initiatives and voluntary CR practices is likely to be in the area of business and human rights, following on from the work of Prof John Ruggie from the Kennedy School of Government on his UN mandate on the topic.

**Today’s Cranfield seminar invites debate and dialogue over how far, under what circumstances and with what conditions, CR might form an alternative, precursor or complement to further regulation of business at a UK, EU and international level.**

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<sup>19</sup> Conservative Party (2008), “A light but effective touch” Final Report of the Conservative Party Working Group on Responsible Business, March 2008.

<sup>20</sup> [www.corporatejustice.org](http://www.corporatejustice.org)