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## Toward a 21st Century Social Contract

by Carl Ferenbach, Berkshire Partners LLC and the High Meadows Foundation,  
and Chris Pinney, Aspen Institute

**D**uring the 20th century, industrialization and the related rise of service and consumer economies and financial markets led to enormous improvements in human working and living conditions. The economic prosperity that drove these improvements was made possible in large part by the growth in productivity and economic output of a growing and successful business community—a community made up of organizations ranging from large multinational corporations to local family businesses and everything in between. Governments in turn supported this growth through thoughtful regulation, leading to the evolution of highly effective capital markets, fair and flexible labor markets, and consumer markets characterized by beneficial consumer protections. While the private sector provided the capital, jobs, and taxable income, governments increased their revenue, making it possible for them to expand the social safety net in addition to their traditional roles of providing justice, infrastructure, governing laws and military protection. This “contract” between the private and public sectors produced periods of unprecedented economic and human success despite periodic troughs and conflicts.

In the pages that follow, we argue that the Great Recession has exposed the need for a substantial revision of this once successful compact. We will do so not from an ideological or political perspective, but from a basic premise that the functional success of government, as it has evolved in developed economies, and the productivity and interests of private enterprise should be brought together in a new and more effective form of collaboration. Our purpose here is not to prescribe exactly how this should occur, but to start a discussion of key issues that should be considered in developing these new forms of collaboration and to reflect on the role that business in particular might play.

To achieve this collaboration, there are two critical challenges that must be met. The first is the creation of an oversight and regulatory framework for the private sector that is equal to the challenges of a 21st-century global marketplace. This framework must be able to protect the public interest while at the same time allow for continued innovation and growth in capital markets and the private sector. Responsibility for the development of this framework cannot be left to governments alone, but should be shared equally and “owned” by both the public and private sectors. The second

challenge is to find ways to use private-sector capabilities to help governments deliver more effective goods and services, in part through public-private partnerships. Both forms of collaboration are urgently needed and essential to our continued social and economic success.

### The Role of Markets and the Public Interest

First we offer some context. It has often been observed that markets are among the most productive of human creations. Markets have sometimes proved to be too small or illiquid, and so required outside help as well as regulatory oversight. Some markets have also turned out to be vulnerable to control and manipulation by one or two successful participants, also requiring intervention. But in spite of all their imperfections, active and well regulated markets for capital, for products and services, and for all variety of human wants and needs have become the dominant means—in developed and emerging economies alike—for setting prices, allocating social resources, and promoting global trade and economic growth. A second human invention that has been critical to the development and functioning of markets in the U.S. and most developed economies is the limited liability corporation. When corporate interests have been aligned with those of both their investors and their important “stakeholders”—a group that includes governments, regulators, and local communities as well as customers and employees—such organizations have produced much social good as well as private financial gain.

Nonetheless, during the past 25 years, corporations and governments have evolved in very different ways. During the first four decades that followed the Great Depression of the 1930s, labor—primarily industrial workers—mobilized political support for government backing of its agenda, chiefly bargaining rights. The outcome of this process was an implicit social contract binding labor, management, and government. Governments during this period expanded their role. In the U.S., for example, new laws were enacted that expanded government oversight of commerce and social well-being. New departments responsible for transportation, education, health and welfare, and commerce were organized to meet perceived needs or market failures. These semi-autonomous government bodies were often overlaid by federal commissions—such as the FCC in communications and the FTC in trade—that were

granted their own rule-making authority. Legislative bodies retained budgetary authority, but they generally acted in response to proposals initiated by the Executive branch, which in turn had its own infrastructure. This complex decision-making structure remains largely in place today. Complicating matters further are the frequent leadership changes within this structure that naturally affect performance.

During the same period, however, the evolution of business and the private sector, the other partner in the social contract, has taken a very different path.

### The Impact of Globalization

Beginning in the 1980s, the private economy began accelerating its movement beyond the constraints of national economic boundaries and toward a globally integrated economic platform. This shift was made possible by innovations in communications, information processing technology, and shipping in combination with lowered tariff barriers. Such advances allowed companies to operate effectively on a global scale while gaining access to a new labor market of two billion underemployed people. This labor force, primarily in Asia, was capable of producing competitive products and services at a fraction of the costs of labor in developed economies. At the same time, technology increased productivity while greatly reducing information gaps and response times, making decisions possible at organizational levels closer to markets, and creating very different customer and consumer expectations. Among the outcomes were much flatter and more nimble organization structures. For example, if you wanted your supply chain to begin in China and end in a Walmart in the U.S., you couldn't centralize decision making in Bentonville, Arkansas (home of Walmart's headquarters); it would be too cumbersome and costly. So business decentralized, outsourced, reduced cost, broadened markets, and increased its reach. Such changes led in turn to the rapid growth of global corporations, financial as well as nonfinancial. Today 44 of the largest 100 economies in the world are businesses with power and influence exceeding that of many nation states.<sup>1</sup> This reality has fundamentally changed the relationship and dynamic between the public and private sectors while revealing the inadequacies of a social contract designed in the context of national economies and nation states.

### Adaptability Becomes an Organizational Imperative

In their new book, *Repeatability*,<sup>2</sup> Chris Zook and James Allen, who lead the Strategy Practice at management consultant Bain & Co., make a compelling case that, in this fast-changing global economy, “complexity has become the silent killer of growth strategies.” They argue that successful strategy is chang-

ing in three ways. First, it is less about a detailed plan and more about a general direction and a few critical initiatives. Second, it is less about anticipating how the world will change—it happens too fast (when did you first hear of “Black Swans”)—and more about rapid testing, learning, and adapting. And third, strategy is becoming indistinguishable from the functional responsiveness of an effective organization. Hierarchy is the enemy of this kind of approach to strategy.

The consequence of this new strategic operating environment has been a widening gap between the capabilities of nation states and those of private and public companies. While companies have “flattened” and adapted to rapid change, national governments, which must now compete for corporate investment and jobs in a global economy, find themselves hobbled by highly complex decision making processes and centralized 20th-century bureaucracies designed for a different time. Recognizing this, some governments in OECD countries began some years ago to divest previously nationalized businesses as well as other services and responsibilities to the private sector.

The first wave of such divestitures began in the 1980s, with governments transferring ownership of assets to private operators and investors in areas such as power generation, telecommunications, transportation, and public housing. In one representative example (discussed at greater length in the inset box), a consortium led by Wisconsin Central, a U.S. operator of freight railroads, acquired and then increased the efficiency and profitability of freight railroads in the U.S., U.K., New Zealand, and Australia. In each of these cases, customers had developed new expectations for transport services and had other options if the railroads couldn't meet them. The railroads had to adapt to these new customer needs while also developing competitive cost structures. While in government hands, such operations were constrained by political considerations, both service and labor-related, that made them both inefficient and high cost. High costs meant operating losses and underinvestment, resulting in declining service levels and poor customer relations. In private hands, they became successful participants in the economy.

Another example of a successful divestiture was the U.S. government's creation of the Affordable Housing Tax credit. The LIHTC is currently the most important program through which the federal government encourages the development of affordable rental housing. It provides incentives for private investors to provide equity for the development of low-income housing in return for federal tax credits—a dollar-for-dollar reduction in tax liability. In the years since the program's inception, an entire industry has grown up around syndication of the tax credits and the development and financing

1. Tracey Keys and Thomas W. Malnight, *Corporate Clout: The Influence of the World's Largest 100 Economic Entities* ©Strategy Dynamics Global Limited 2009.

2. Chris Zook and James Allen, *Repeatability: Building Enduring Businesses for a World of Constant Change*, Harvard Business Review Press, 2012.

## The Case of British Rail

The privatization of the British Rail (BR) freight businesses was the last of a series undertaken by the Thatcher government. In preparation for being taken private, the freight business had been broken up into six separate businesses. With the rail network itself (the track) serving a considerably larger passenger demand nationwide, the freight business, even with £1 billion in annual revenues, looked small by comparison. Control of the track was not part of the business, in contrast to the freight business in the U.S. Each carrier had to negotiate track access with a separate company, initially called RailTrack, that controlled, managed, and maintained the network. In addition, there was no exclusivity of network access. A new operator could buy equipment and, provided it met all the necessary operating standards, offer services to shippers in competition with the established carrier.

BR was losing money everywhere, including freight—both in the aggregate and in most of the six operators created for privatization. And it had underinvested in capital equipment for freight. It maintained a fleet of locomotives, built locally, that, as observers enjoyed noting, spewed oil as they passed by. And BR's "wagon fleet" (British for "railcars") was old and too often unsuited to its current tasks. The company also employed far more people than it needed. With this state of affairs in 1995 and 1996, the six freight operations were offered for privatization.

Our group, which consisted of an operating lead (Wisconsin Central International) and two financial partners (Berkshire Partners and New Zealanders Fay Richwhite & Company) bought five of the six freight operations, and then re consolidated and renamed the resulting company English, Welsh & Scottish Railway Ltd. The new team immediately ordered 280 new freight locomotives and began "retonnaging" the wagon fleet to meet customer and prospective customer needs. We also developed a new network operations center to upgrade information flow and improve train operations. And we began the more arduous work of addressing on-the-ground train operations and improving customer relations. Also, as part of the transaction, we made it clear that a significant number of people would not be needed in the privatized business. A generous redundancy payment—

which was effectively part of the purchase price—was specified by the government and became part of the transaction. The work force was right-sized, or nearly so, at the outset, while those who elected "redundancy" had a cushion—a decision by the British government that we appreciated and applauded.

As we discovered during our efforts to improve service, customer histories were particularly difficult. Customers like the coal suppliers or the coal-fired power generators had only recently been privatized themselves. While nationalized they had experienced no competition for their business; and so, in contract negotiations, there had been no active price signal. There was no market or only a very limited market for these transportation services. The resulting contract negotiations had too often become acrimonious and, when coupled with subpar service, had resulted in poor customer relations. With the generators now free to explore alternatives to lower costs and improve services, and with new rail service becoming available as it took advantage of the open access rules, this all changed. EW&S had to improve or lose business—and it had to increase its own productivity or lose money.

Other customers had similar stories. And there were major efforts to create new services for shippers of all kinds. Among the acquired businesses was one with the rights to move freight through the Channel Tunnel. As the EU countries in the early 2000s adopted the same open access regime available in the U.K., EW&S became a freight carrier in France, Belgium, and Spain, building a substantial and growing business in competition with the established railroads there, operating under the Euro Cargorail brand.

After 12 years—the last seven of which I served as chairman—EW&S and Euro Cargorail had reached the point where they needed additional capital to continue to grow and develop. In 2008 Deutsche Bahn, a large and well-capitalized global logistics company, acquired control. EW&S had become a well-established, profitable business, generally felt to be among the best railfreight operators anywhere. And our investors after 12 years were rewarded with a meaningful financial gain.

—Carl Ferenbach

of LIHTC projects. The introduction of the LIHTC has dramatically improved the quality of public housing in the

U.S. by helping finance over one and a half million affordable housing units since its introduction in 1986.<sup>3</sup>

3. Mihir Desai, Harvard University and NBER, Dhammika Dharmapala, University of Illinois at Urbana-Champaign, and Monica Singhal, Harvard University and NBER, "Tax Incentives for Affordable Housing: The Low Income Housing Tax Credit," 2009.

## A Social Contract in Crisis

As we move further into the 21st century, fast-moving, flexible business corporations continue to innovate, shed hierarchy, and increase productivity while at the same time often avoiding direct responsibility for reductions in employment, loss of health benefits, or reductions in retirement benefits that occur particularly in periods of economic downturn. Such reductions have created a growing dependency on public services and support at a time when national governments and public agencies have become less and less able to meet the demands. These consequences are now manifest in deeply indebted OECD sovereign nations, states, and municipalities with health care commitments to large, aging populations and social security or pension obligations to both public employees and the general populace. That large portions of these future obligations are unfunded and unsustainable has been well documented. On top of these obligations, the consequences of the Great Recession have led governments and central banks to provide financial support for their banking systems. As a result, many OECD governments have now reached a point of considerable stress, deeply in debt and unable to maintain the core foundation and investment on which their economic competitiveness and social well-being depend.

Although the most obvious examples are countries like Greece and Spain, there is every reason to believe that other countries are experiencing similar distress. This state of affairs also bedevils the U.S. Michael Porter and Jan Rivkin of Harvard Business School recently conducted a survey that brought responses from 10,000 HBS alumni on U.S. competitiveness, and published the findings in the *Harvard Business Review* under the title “Prosperity at Risk.”<sup>4</sup> The conclusion: America is still strong in critical areas, but not keeping pace with other economies, especially emerging economies. What are the perceived weaknesses? At the top of the list are the American tax code, K-12 education, macroeconomic policies, infrastructure, and workforce skills—to name a few. One might also add our rapidly increasing national debt and massive future obligations to the elderly.

In sum, the Great Recession has exposed the erosion of the social contract that served as the platform for economic prosperity and social progress for most of the past 60 years. Countries with great resources that should be capable of meeting human expectations over time are struggling with massive resource allocation problems that have been exacerbated by the inelastic structure of the public sector and the far more flexible structures in the private sector. Business corporations for their part have accumulated liquid resources estimated in the trillions resulting from capital reductions,

increases in productivity through investment in technology and low levels of investment in newer or riskier ventures. The consequence has been to make clear the growing unsustainability of the historical preference for governments as the sole deliverer of social services and the urgency of the search for new models and solutions. Not surprising in this regard, a 2009 Waggener Edstrom Poll<sup>5</sup> found that 60% of consumers said they believed that businesses are in the best position to create positive results on social issues, as opposed to only 14% who cited governments. The question we now face is how best to address this misallocation of human and physical resources in developed economies and how to define a new framework for responsibility-sharing by the private and public sectors that will enable us to sustain economic and social progress in the 21st century.

## Defining a New Role for Business

“Reinventing government” has been a theme of public policy for much of the past two decades. The Obama administration recently announced an initiative to reorganize government, with the aim of streamlining regulations, improving the speed of decision making, and reducing duplication and overlap in services. Similar attempts by previous administrations suggest that significant progress on this front will be difficult. Faced with shortages of human, political and financial capital, governments alone simply cannot drive the innovations we urgently need to address the challenges we face.

If not governments, then who? As the poll above suggested, society is now looking to business for leadership in helping create the renewed social balance. Brian Griffiths, an economist and Vice Chair International at Goldman Sachs, has proposed a starting point from which to address this challenge. Griffiths, who is a member of the House of Lords and served Margaret Thatcher as Senior Policy Advisor, has developed support for a new Centre for Enterprise, Markets, and Ethics at the University of Oxford. The center is housed in Wycliffe College, which is comparable to a Department of Religion in an American university, and its aim is to bring philosophical and theological perspectives to bear on a public dialogue about the social purpose and roles of corporations and markets.

In a similar vein, the Aspen Institute Business and Society program has been exploring the changing role and responsibilities of business in society with senior corporate leaders through initiatives such as its Corporate Values Strategy Group.<sup>6</sup> This initiative involves working with senior corporate leaders and other stakeholders to address the challenge of “short termism” and to draft public policy

4. Michael E. Porter and Jan V. Rivkin, “Prosperity at Risk: Findings of Harvard Business School Survey on U.S. Competitiveness,” January 2012.

5. Waggeneredstrom 2009 Global poll <http://waggeneredstrom.com/news/eighty-six-percent-of-consumers-believe-profitable-businesses-can-address/>

6. <http://www.aspeninstitute.org/policy-work/business-society/corporate-programs/corporate-values-strategy-group>

ideas designed to create a market and regulatory environment that is more conducive to long-term value creation, in part by appealing to a more diverse set of market actors. Aspen's Business Education program has also focused attention on the important role of business schools in preparing business leaders for the challenges of 21st-century business management and leadership.

In this context, a recent article in the *Harvard Business Review* by Michael Porter and Mark Kramer of Stanford University proposes a new theory of the firm, predicating that public companies aim to maximize not just shareholder value, but also the creation of "Shared Value."<sup>7</sup> The concept of Shared Value expands the role or mission of business to encompass societal outcomes without sacrificing long-run financial returns to investors. Porter and Kramer posit that the single-minded objective of producing returns for financial markets participants is too narrow, and that business organizations must also address broader issues of social need. To this end they argue that business purpose must encompass a human dimension. They remind corporate managers that there is significant room for business to improve the lives of lower-income people—in part, by learning to produce and sell products and services to these communities—while at the same time caring for the environment and earning an adequate return on capital invested.

And in fact the last two decades have seen a wide range of businesses and business coalitions beginning to explore these themes. These range from global initiatives such as the World Business Council for Sustainable Development<sup>8</sup> to national initiatives like Business Civic Leadership Center<sup>9</sup> at the U.S. Chamber of Commerce to industry initiatives such as Equator Principles for the financial sector.<sup>10</sup> Many of these engage actively with external stakeholders to address social and environmental challenges, set standards and norms for their membership, and orient business managers and leaders in new ways to understand how business can increase its contribution to society while reducing potential negative impacts.

The Environmental Defense Fund has, for example, organized a program called EDF Climate Corps that places MBA and MPA students in summer fellowships with companies, cities, and universities to find ways to reduce energy consumption while maintaining or increasing output. This "win-win" reduces both operating costs and emissions of greenhouse gases. In 2011, 96 EDF Climate Corps fellows worked with 78 organizations—an impressive increase from the base of seven fellows who were placed in 2008, the first year of the program.

Many major corporations are finding their own ways to

produce similar outcomes. WalMart, to pick just one, has worked with several NGOs on projects like supply chain management to increase efficiencies and to reduce energy and emissions or to reduce or eliminate packaging. Another example is the enormous interest in extracting shale gas in the U.S., which promises, among other potential benefits, to reduce our dependence on coal for power generation. This potential will be reached only if producers, transporters, and distributors proactively help win adoption of strong standards to protect their neighbors and the environment. Several market participants, including some of the largest producers with the most reputational and financial risk, have already learned this lesson and called for protective laws and regulations to be put in place.

Along with the initiatives described above, there are also a growing number of think tanks and other nonprofits that are exploring the possibility of a new social contract, with new roles for business leaders and the private sector. One such nonprofit is The Alliance for Business Leadership,<sup>11</sup> an organization that we and other business and thought leaders are now engaged in launching from our base in the Boston area. Membership in this organization requires a public commitment by business leaders to a set of principles that includes a commitment to work collaboratively with government to create and deliver solutions to the public policy challenges we face. The Alliance program agenda currently focuses on three areas: economic development and jobs; health promotion; and responsible government. In each area, Alliance members are asked to pursue the Alliance's goals through a combination of public policy advocacy and business strategy and practices as appropriate. Key areas for focus include an education system that gives people the skills needed by today's employers; a health care system that incorporates prevention and holds both public and private actors accountable; and development of a fair and greatly simplified government revenue model (taxes), along with a sensible division of government "costs" between operating and capital.

### A Critical Role for Investment Capital

Another important contributor to meeting the challenges of forging a new social contract are investors and investment managers. Investment management has undergone very significant and beneficial changes during the last 20 years. Large pools of capital accumulated in public and private retirement funds, in the endowments of major universities and foundations, and in sovereign wealth funds have been managed with the aim of diversifying their asset allocations, creating new and important asset classes. Such investors are

7. Michael E Porter Mark R Kramer, "Creating Shared Value," *Harvard Business Review* 2011.

8. <http://www.wbcsd.org/>

9. <http://www.bclc.com/>

10. <http://www.equator-principles.com/>

11. <http://www.allianceforbusinessleadership.org/>

today the major sources of capital for leading venture capital firms, various forms of private equity, and real assets such as property, oil and gas, and timber.

These diversified capital pools are earning returns that are superior to the average returns in public equity and bond markets while supplying capital directly to managers within these asset classes, enabling them to invest, innovate, grow, and diversify developed economies. Unlike the 1970s, when capital flows were restrained by a combination of market conditions and government policies, most developed economies have not experienced more than brief shortages of risk capital since the financial meltdown of 2008, and both public equity and high yield debt markets have experienced substantial recoveries. Much of the financial creativity that will be needed to facilitate the public/private collaboration we envision resides in these capital pools and the organizations in which they invest. Should collaborations develop, these large, quasi-private capital markets will be important facilitators and supporters.

### Closing Thoughts

We are concerned that the benefits of these developments will remain unrealized without a new collaboration between business and government, one in which the essential strengths of each are combined to achieve a broader societal outcome. Lord Griffiths reminds us that businesses must continue to find ways to increase their productivity and profit. We in the developed economies can continue to make our labor valuable to others only by increasing its productivity and earning our cost of capital. But we must have a broader sense of purpose. It must be based on a principle—whether you accept a theological basis for it or not—of the common good, a principle that respects the planet and future generations and that will enlist the emotional allegiance and commitment of the voting public. The outmoded social contract of the 20th century under which we still labor will not allow us to deliver these outcomes.

We see daily in our political process how difficult change will be. But we should also be encouraged by our successes in the last century in addressing a number of difficult human problems. Then we greatly improved the conditions and pay of manufacturing workers and saw them join a much larger middle class. We also developed, in the private economy, a workable set of both retirement and health benefits, albeit incomplete and too frequently maladministered or abused. And we provided necessary and affordable job and product

protections and began a process of regulating our environmental excesses.

But this progress did not come without mistakes. We have permitted excesses in retirement benefits at the public employment level, overinsured the health needs of the elderly, and allowed inefficiencies and deficits that now threaten our economic future. The financial sector has taken unnecessary and unsustainable risks that have destabilized the financial system and jeopardized social progress. To meet the needs of our societies, both business and the public sector will need to be more accountable and take more responsibility for their actions and support each other to this end. Government will need to persuade business that essential human needs—employment, universal health insurance, capacity to meet later in life needs, management of our natural resources and our environment—are burdens that it must share to a greater extent than it does today. Business will also need to take more responsibility for “self regulating” its impact on society and the environment, and manage for the long-term interests of shareholders and society. It will need to bring to government its lean and focused management capabilities, eliminating unneeded redundancy and high cost, non-competitive services. For business leaders, helping to address such problems while continuing to produce financial returns that ensure their organizations’ access to capital will be among their greatest challenges. At the same time, it will be essential for government and the public to recognize that businesses, in their efforts to preserve their access to capital, are continually confronted with difficult tradeoffs—and that they will fall short from time to time in meeting the expectations of *all* of their stakeholders. Without such understanding and collaboration, without the building of these bridges, it is hard to see how we will advance beyond where we are today.

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