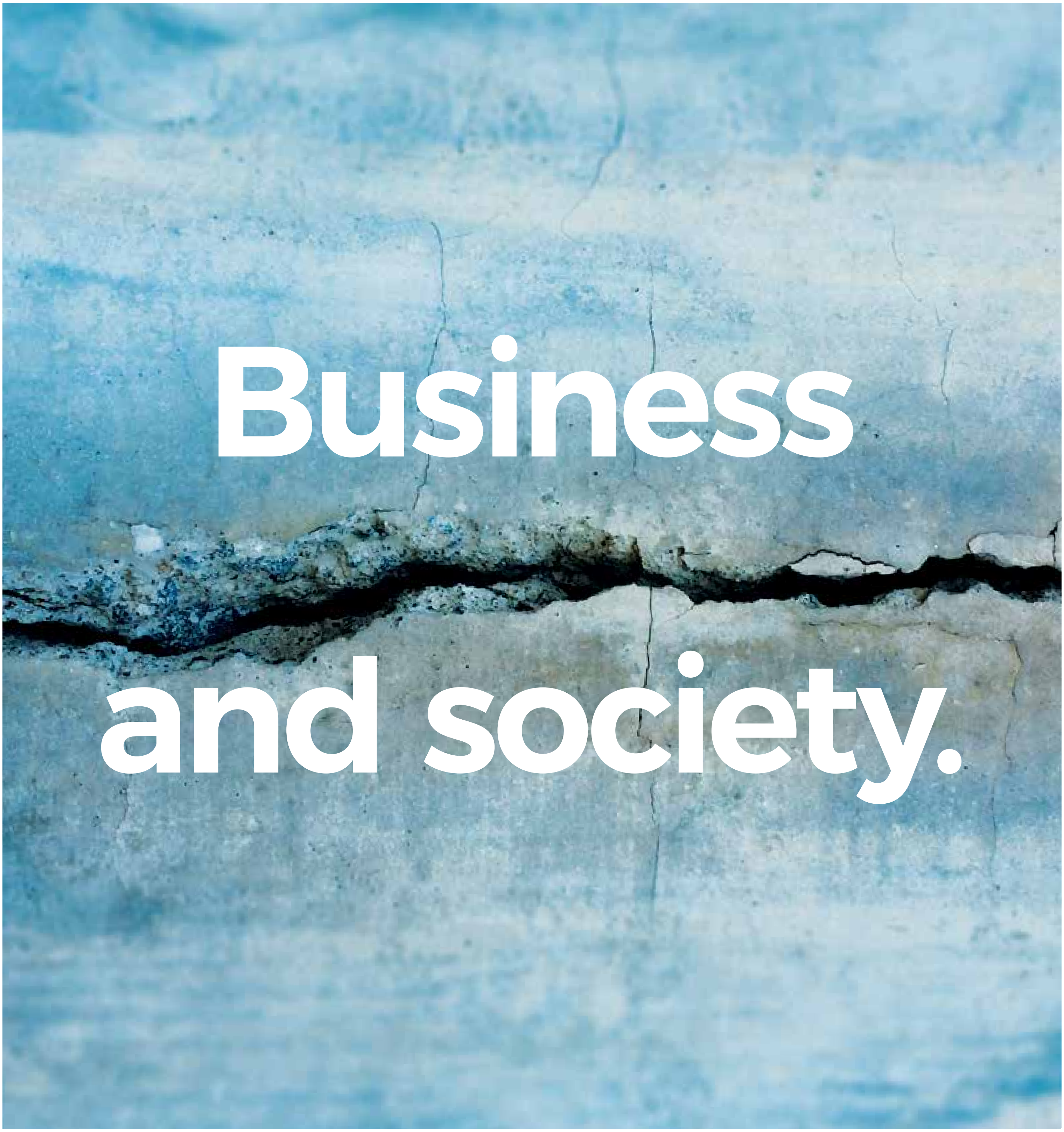
How is the relationship between business and society influencing global events?

How can business respond to current market uncertainty?

How might the relationship be repaired over the longer term?

Business and society.



Freshfields

There is no doubt the financial crisis and its aftermath have damaged the relationship between business and society.

From Brexit to Donald Trump, Jair Bolsonaro to Italy's Northern League, global politics has been flipped on its head in recent years. The reasons why have been extensively debated, with everything from "elites" to immigration in the spotlight. At their heart, however, is a sense that the world is not working for the "ordinary person" – and that globalization is to blame.

So what does this upheaval mean for global companies – and where did the process begin? There is no doubt the financial crisis and its aftermath have damaged the relationship between business and society. Since 2008 there has been some measure of economic recovery in the developed world but the benefits have not been shared. Populists use the resulting anger as a source of strength, which in turn drives established politicians to adopt more populist positions. The impacts of this shift are profound – on an operational level business must adapt to the breakdown of Western multilateralism and its effect on international trade, and the increasing influence of politics on cross-border M&A. It is shaping the laws and regulations that govern corporate tax, environmental standards and the responsibilities of business in protecting human rights. And authorities are being equipped with new powers to tackle corporate misconduct via personal sanctions, which in turn is fueling debate about what society expects of business leaders in changing times.

These are not the only sources of disruption to the business/society relationship. The lightning advance of technology is creating new models that transform markets and alter the dynamic between companies, consumers and employees. These disruptive developments raise complex questions about the future of employment and the responsibility of corporations toward those whose jobs are under threat. And reputations must be protected in a world where business frequently finds itself on the wrong side of the argument and truth is in short supply.

We are acutely aware of the difficulties this situation presents, both as an international organization ourselves and because we help our clients at the sharp end of the changing environment – law and regulation is, after all, one of the main ways society communicates its minimum expectations of business. The issues that corporations must tackle operate on two levels – those that disrupt their activities today, and the more fundamental question of how to improve the business/society relationship as a route to greater operational certainty tomorrow. Those that can navigate both will gain a competitive advantage.

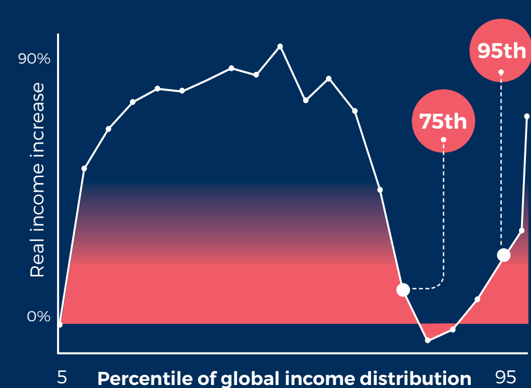
In order to begin repairing the business/society relationship, we believe there are three questions corporations should ask themselves. Find out more on the back page.

The business/society relationship in six charts.

1

Globalization has created winners and losers ...

The famous "elephant graph" by Serbian-American economist Branko Milanović shows the winners and losers of globalization. Real incomes among the world's poorest people (those on the left of the chart) rose massively between 1988 and 2008. Those of the very richest in the West, shown as the "trunk" on the right, did likewise. However the 75th to 90th percentiles – which includes many lower-income workers in developed economies and upper-middle-class residents in emerging markets – failed to keep pace with inflation. When the crash happened the situation was magnified. Today, the proposed remedies run from Trump's "America First" agenda to Bank of England Governor Mark Carney's calls for "redistribution."



Source: World Bank

Populists also feed off the sense that citizens lack “control.” That was the free-floating word via which the Leave campaign found its way into British hearts.

Before attempting to suggest routes through the current volatility, it is important to examine in more detail where we stand today – and why.

After a period in which shock has followed shock, it is tempting to cast everything in a negative light. But as Lionel Barber put it in the *Financial Times*: “Brexit and the Trump triumph mark a revolutionary moment. Not quite 1789 or 1989, but certainly a thundering repudiation of the status quo. [However] we are nowhere near a Great Depression. The US economy is approaching full employment … Credit is flowing. Corporate profits are up. The trouble is that swaths of the population, often those living outside the great cities, have little sense of the economic recovery.”

While it is reductive to draw encouragement from purely economic indicators, the last point is key. Research shows that in times of rising prosperity, people are more optimistic and can better tolerate rapid economic and social change. But for at least the last decade that cushion has been absent. Since 2005, more than 65 percent of households in the West have experienced flat or falling wages – reversing a dynamic that has prevailed since the Second World War.

Recent research by the Resolution Foundation shows UK millennials (those born between 1981 and 2000) are set to become the first generation in centuries to earn less than their parents over the course of their working lives; a study by *The Guardian* shows this picture also extends across much of the Western world.

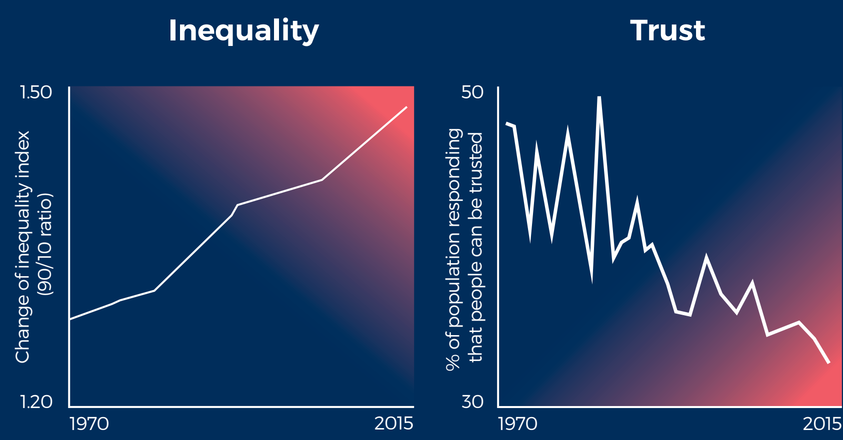
Contributing factors such as sluggish productivity provoke no emotional response. But globalization is a different story. The populist narrative is that as cheap goods made in poorer countries have flooded into developed markets, so manufacturing jobs have moved in the opposite direction, hollowing out working-class communities in former industrial heartlands. This message struck a chord and swept Donald Trump to power, even though data shows “reshoring” has been the dominant trend in North America since the turn of the decade. Low-skilled factory roles *have* disappeared but this has been driven by the advance of technology. No amount of policy reform is going to bring them back.

Then there is the wider issue of economic inequality, identified by Thomas Piketty in his best-selling book *Capital in the Twenty-First Century*. Piketty crunched centuries of data to show that wealth grows faster than income, and that the gap widens in periods of low economic growth like the one that followed the 2008 slump. Those who are already well-off are pulling further away from those who are not.

2

Reducing trust toward others …

Data from the IMF paints a stark picture of what effect this is having on social cohesion. Figures from surveys in the United States show that as inequality has risen over the past 40 years, so trust toward others has fallen. During the 1970s and 1980s the proportion of respondents who said other people could be trusted fluctuated wildly. But since the 1990s the overall trend has been downward – particularly so since the turn of the decade.



Source: IMF; Economist Intelligence Unit

This dynamic is driving the surge of populism in the West. As Fareed Zakaria wrote in *Foreign Affairs*, populists on both left and right see themselves as “speaking for the forgotten ‘ordinary’ person” and share a “suspicion of and hostility toward elites, mainstream politics and established institutions.”

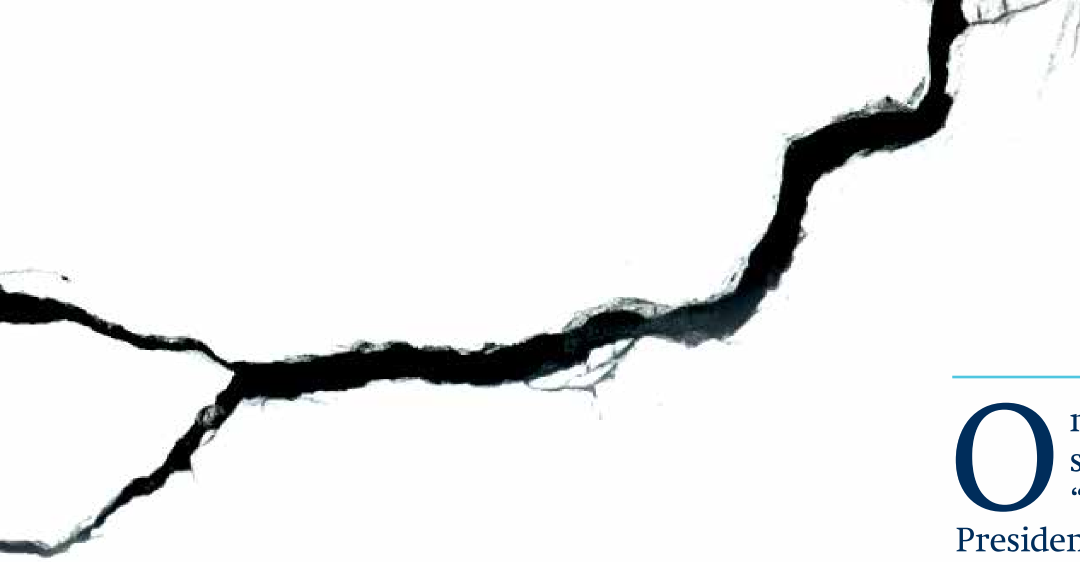
Since 2005, more than **65%** of households in the West have experienced flat or falling wages

Populists also feed off the sense that citizens lack “control.” That was the free-floating word via which the Leave campaign found its way into British hearts during the Brexit campaign. The desire to return it, somehow, to local populations has now become mainstream.

Listen to Mark Carney, Governor of the Bank of England, raise the fear that society could turn its back on open markets. Or Theresa May outline her vision of a post-Brexit world in which the UK is master of its own borders.

Socially, populists play on the idea that cultural control has somehow been lost to an influx of migrants (“globalization made flesh” in the words of the *FT*’s Martin Wolf). Indeed Donald Trump’s controversial agenda and May’s Brexit strategy both have immigration at their core. Marine Le Pen’s anti-immigration, antiglobalisation rhetoric shaped debate in the French presidential election, while François Fillon gained early success on a hardline immigration ticket before his campaign was beset by scandal. And in Australia – whose visa policy was held up by Leave campaigners as a model for post-Brexit Britain – Prime Minister Malcolm Turnbull toughened his country’s entry criteria to “reduce competition from overseas.”

The speed at which the world is changing as a result of the populist surge is bewildering – with indices of policy uncertainty way above their historical average on both sides of the Atlantic. And in such a volatile environment, businesses have to change course. After being criticized by Mr. Trump for shipping jobs outside the United States, Ford chose Michigan over Mexico when expanding its production facilities – even before the new president had taken office.



In times of rising prosperity, people are more optimistic and can better tolerate rapid change.

One casualty of the populist shift has been global, "win-win" trade agreements. President Trump's "America First" agenda casts trade as a zero-sum game in which the United States will succeed at the expense of others; he believes that bilateral negotiations will allow him to use his skills to get a better deal for America.

This stance is recasting the established international order – Mr. Trump pulled out of the Trans-Pacific Partnership (which promised to dismantle trade barriers with Asia), halted progress on the EU-US Transatlantic Trade and Investment Partnership, renegotiated NAFTA and launched a tit-for-tat trade dispute with Beijing. His confrontational approach was signaled from his earliest days in office, when he handed China hawk Peter Navarro and Robert Lighthizer – a prominent advocate of protectionism – key roles on his trade team.

This changing mood is not confined to the United States. The EU-Canada Comprehensive Economic and Trade Agreement (CETA), for example, only just survived a tussle with Wallonia after its parliament raised concerns that the deal would erode labor, environmental and consumer safeguards.

The influence of politics is extending into M&A activity. Even in China, where President Xi pledged to uphold global trade and investment, the ruling party introduced measures to curb domestic companies' outbound acquisitions in a bid to control capital flight. A raft of measures to protect strategic assets from overseas acquirers has been introduced around the world, including in the United States. While President Trump's administration is pro-business, there is intense scrutiny on transactions that threaten domestic job losses. Robust deal narratives and sophisticated regulatory strategy are increasingly vital to getting acquisitions over the line.

Politicians are keen to demonstrate that they are on the side of the ordinary citizen and the "nation" as a concept. The UK government has signaled its intent to boost its powers to block deals that could have an impact on national security. Foreign investment reviews have been a growing trend globally for several years, but before Brexit brought issues of national identity to the surface there was little discussion of UK deals in these terms.

Germany, too, is tightening its rules around foreign acquisitions of technologies "key to the future of society." To hear Deputy Chancellor Sigmar Gabriel push for similar legislation at EU level and say that German companies and German jobs will not be "sacrificed on the altar of free markets" shows the government's desire to protect domestic technology from Chinese advances.

For years the tax policies of multinationals have provoked a visceral reaction among the "left behind" – the ability of big business to shift profits to more beneficial jurisdictions has fueled the notion that the elite play by a different set of rules.

A series of reforms – the OECD's base erosion and profit shifting (BEPS) proposals, which G20 signatories are in the process of implementing, and the EU's Common Consolidated Corporate Tax Base (CCCTB), which is under discussion for 2021 – aim to link the payment of tax to the countries where profits are made. These are radical projects.

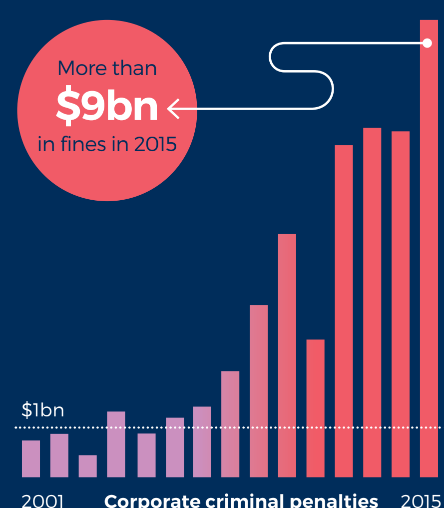
The former establishes the requirement to report profits country by country; the latter is more controversial in that it would introduce a uniform way for governments to calculate taxable profits and proposes pooling and distributing group tax revenues to the states where assets, employees and sales lie.

If you accept the logic that BEPS and CCCTB are a response to society's call for corporations to pay more tax, then the debate in Europe has sometimes taken a confusing intellectual shift. Theresa May has repeatedly spoken of her desire to create an economy that "works for all" and stressed that everyone should pay their "fair share." Yet she also raised the prospect of cutting UK rates after Brexit. Her calculation appears to be that voters will be more tolerant of low corporate taxes if the alternative is fewer jobs.

3

At the same time standards of corporate conduct appear to be in decline ...

Driven by tougher regulation and more intrusive investigations, fines for corporate criminal offenses have surged in the United States since 2008. For many this is evidence that the system isn't working. While the picture is more nuanced (many of the offenses are historical and therefore rising fines are not necessarily evidence of falling behavioral standards), it adds to the drumbeat of a corporate class that's out of touch with reality. In response authorities have been equipped with new powers to impose personal sanctions on business leaders – new and boosted legislation in the UK, France and New Zealand, for example, means senior executives can now be charged for failing to prevent certain economic crimes by their staff. Whether more prosecutions follow remains to be seen, but the fact populist laws are being drafted by mainstream leaders is a sign of the new world.

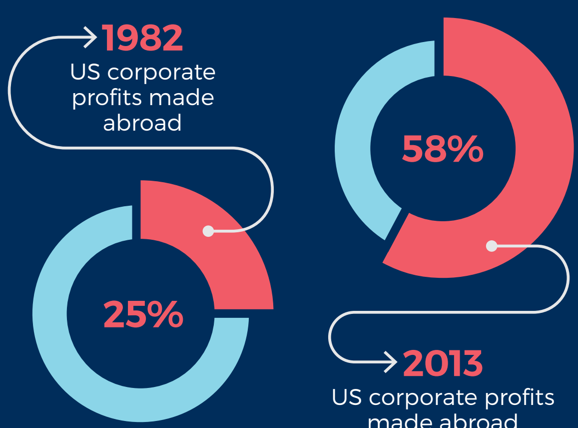


Source: brandonlgarrett.com/blog (cited in *The Economist*)

4

Multinationals seem increasingly stateless …

One of Donald Trump's principal targets is offshore cash. The amount of money made by US businesses from their direct investments overseas has been rising for the past 30 years – and the share of it made in low-tax jurisdictions has also been growing. In Europe this has caught the attention of the EU Commission and is what drove the development of the BEPS proposals, which aim to tie taxation more closely to the places where profits are made. It is also the motivation behind Donald Trump's tax reforms, which aim to bring US corporates' offshore cash back to the United States. While the narratives differ – BEPS is ostensibly about corporations paying their "fair share" while Trump is more interested in job creation – both are signs of governments sending the message that borders matter.



Source: Gabriel Zucman, *Journal of Economic Perspectives* (cited in the *Financial Times*)

Donald Trump's reform of the US tax system included an incentive to bring cash otherwise held overseas back into the United States, and a rate cut designed to stimulate the domestic economy and remove the incentive for inversions. Even before the election the United States had not signed up to elements of BEPS, while many in Congress view the EU's state aid investigations as evidence of anti-Americanism. But cranking up the heat on interstate tax competition threatens to undermine the cooperation needed to embed tax reforms on a global basis.

Falling tax rates threaten the business/society relationship and put pressure on corporations to articulate their societal contribution beyond their payments to the state. The same will apply as governments loosen the regulatory shackles.

Like Brexiteers, Donald Trump the presidential candidate gained traction by pledging to boost growth by cutting regulation. Again this appears at odds with the anti-elite surge that put him in power, but he, too, seems to believe that an expanding economy will quell any backlash. However, corporations will need to respond carefully – failing to live up to society's expectations invariably results in activist disruption, consumer rejection and pressure from employees. Despite populists claiming to be implementing "the will of the people," it's worth remembering that both the Brexit vote and the US election split the UK and United States down the middle.

President Trump's pitch is that ordinary Americans will prosper with a commander in chief who puts US interests first ("bellicose isolationism" in the words of the *FT*'s Philip Stephens). The US economy has grown under his presidency and continues to create jobs. If the benefits trickle down then the relationship between business and society may improve.

But what if it doesn't? Some economists have suggested the scale of the US tax reduction could lead to damaging budget deficits. Others have claimed his reforms of personal taxation disproportionately favor the wealthiest 1 percent. If, instead of improving the lot of those who voted him into power, President Trump increases the gap between the haves and the have nots, what happens then?

Today just 6 percent of people aged 16 to 26 profess to admire business owners; change the subject to bankers and the figure falls to 2 percent.

Edelman's latest trust barometer reveals the biggest-ever annual drop in public trust of institutions and their leaders, with 53 percent of respondents saying the current "system" is unfair and offers little hope for the future.

53% of respondents to Edelman's trust barometer say the current "system" is unfair

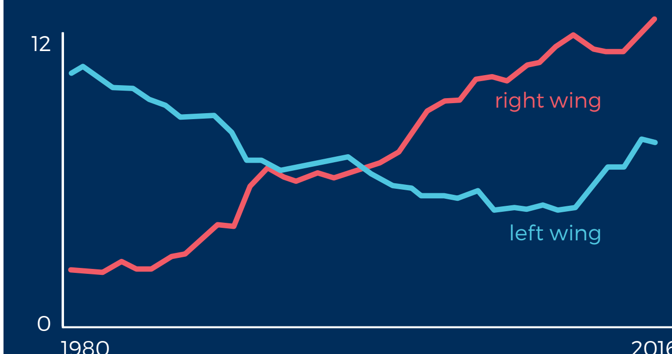
If the popular mood rejects the "statelessness" of large corporations, it also objects to their apparent facelessness when things go wrong. In response, governments and regulators are increasingly using the threat of personal sanctions as a way of improving corporate conduct.

5

Driving a rise in support for populists and a shift in political debate ...

For much of the post-war era, control of major Western democracies passed from one historical party to another, with attitudes toward business tilting (though rarely capsizing) in the handover. But the crash of 2008 has shifted more voters to the electoral extremes, shown here in the dramatic upward swing in support for both left- and right-wing populists since the financial crisis. Driven by widespread rejection of "elites," populist politicians at both ends of the spectrum draw support by pledging to stand up for the marginalized. This often involves intervening in markets and closing borders. Whether or not they ultimately win power, populists exert a gravitational pull on political debate.

Votes for totalitarian and authoritarian populist parties.
As % of votes in most recent national elections*

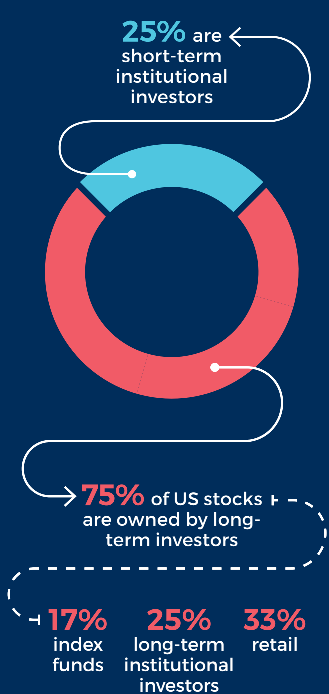


*33 European countries; post-communist states included from the year of first elections
Source: Timbro (cited in *The Economist*)

6

But a better relationship with society could also chime with investors.

The need for business to communicate short-term financial performance – and therefore focus on short-term decision-making – is often used as a reason why its relationship with society is so fragile. Surveys by McKinsey show that in a given situation only half of businesses would make decisions with the long term in mind, yet a recent McKinsey study of US stocks reveals that 75 percent are owned by long-term investors. It may therefore be easier to put societal contribution at the heart of strategy than many business leaders think.



Source: Marshall E. Blume and Donald B. Keim, *Institutional Investors and Stock Market Liquidity: Trends and Relationships*, Wharton School working paper; Thomson Reuters; McKinsey analysis

There was widespread public anger that individuals were not held to account for the credit crisis and the scandals that followed. Fast-forward a decade and regulations are being tightened to make it more difficult for corporate leaders to escape punishment if misconduct is found. In the UK, the government has introduced reforms that shift the dial as far as white-collar offenses are concerned. Borrowing from bribery and tax evasion laws, the changes mean that instead of proving a senior executive actively aided fraud or money laundering, the authorities will simply have to show that they failed to prevent it.

The accountability drive is extending to supply chains, too. In the EU, companies now have to file sustainability reports on their operations in each country in which they employ more than 500 people. Like the UK's Modern Slavery Act – which mandates that companies publish statements online detailing what they have done to investigate the potential use of forced labor – the EU's sustainability reporting lacks punitive provisions. But, says Marilyn Croser of corporate responsibility lobbying group Core, the advantage of these reforms is that they push potential concerns "up to the boardroom, rather than the CSR department." Once again transparency is being used to drive change, with society's relationship with business the force on the lever.

Then there is executive pay – or, more importantly, how much more those at the top earn compared to those at the bottom. Politicians across the world increasingly seek to remind executives that they live in the same world as their staff. Such interventions respond to the sense that boards are out of control, out of touch and unaccountable to their shareholders and wider society.

While the relationship between business and society may be an abstract concept, the quality of that relationship has huge practical significance.

Its deterioration is one of the drivers of the global populist movement, which is influencing the direction of policy, regulation, transactional activity and business risk. And it also sets the framework for the challenges of the future, not least the rise of technology and its impact on employment.

As a firm we are grappling with the issues touched on above, guiding our clients through major cross-border deals under intense political scrutiny, honing our regulatory advice to negotiate national interest concerns and acting at the cutting edge of tax disputes and regulatory investigations. But if we accept that the business/society relationship lies behind the current uncertainty, then improving it should have widespread benefits.

We want to contribute to a better understanding of how businesses can continue to flourish while improving their relationship with society. As a starting point we believe there are three fundamental questions that all businesses need to ask – ourselves included. This article is our attempt to set the context in which we will explore possible answers, in collaboration with our clients and leading thinkers. We hope you will join the conversation.

We believe there are three questions corporations should ask themselves. Find out more on the back page.

Business and society

Three questions businesses should ask.

1

Beyond creating jobs and paying taxes, how do we contribute to society?

Where are our interests and society's interests aligned? Can we articulate why focusing on these interests is good for business? How do we communicate our societal contribution to the outside world – can we move people beyond the prevailing "antibusiness, antiglobalisation" narrative by organizing more clearly around our societal contribution?

2

How does making a positive social contribution drive our strategic thinking?

Social contribution is about more than supporting social initiatives – if we are to make a difference this has to go to the core of our operations. So how does making a positive social impact figure in our decisions (in terms of investments, suppliers, customers, etc)? Are there things we currently do that are incompatible with this? Is there a tension between making a lasting positive difference and short-term financial measures and, if so, how can we manage it?

3

Do we work in a way that considers our contribution to society?

Does our company's "purpose" govern the way our people work and the decisions they make (i.e. do they believe it and buy into it)? Does our culture support our social contribution? Millennials are the largest employee demographic in many countries, including the United States. A recent Deloitte survey reveals that most choose to work for businesses with a strong purpose that make a positive contribution to the world around them; they are also positive about the potential of business "to do good." How can we embrace this dynamic?

Join the conversation.
To hear about upcoming events please contact
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