

Adam Smith's Dinner

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Introduction: The Walls Came Tumbling Down

In 1961, the East German government erected what they claimed was an anti-capitalist barricade. In 1989, this barricade was dismantled by those whom it was supposed to keep apart: the forces it was intended to contain had overwhelmed it. In the aftermath, the victims of Stalinist oppression and the planned economy opted for radical change. Some might have hoped that they would intellectually march resolutely westwards towards the forms of social democracy that had proven so successful in their nearest neighbours – Scandinavia, Germany and Austria – and stop when they had reached a point on the political spectrum with which they felt comfortable, and which worked for them. Unfortunately, they went to the opposite end of political economy. That choice was celebrated by those theorists who wanted our own countries to move in the same direction. Eastern Europe suffered a decline of 50% in its GDP.

Much earlier in 1653, Peter Stuyvesant had erected an earth and wooden wall to protect the westernmost settlement of a great commercial nation from those they imagined to be barbarians. In 1699 Stuyvesant's barrier was dismantled by the British, who replaced it with a street named after the wall. So it came to be that one of the most inconsequential walls in history became one of history's most famous streets. I am not sure if the Dutch had left some tulip bulbs on either side of the wall, perhaps as a reminder of capitalism's first bubble, and an inspiration to later bubbles. However, many of the victims of the latest burst bubble are pretty keen to tear down that Wall.² As in 1989, they want to take action against the guardians of the system that failed them. And the more they suffer, the more likely it is that they will demand radical change, and the more likely that the resulting change will go too far – as seems to have been the case in Eastern Europe after the terminal crisis of communism, and in the majority of democracies that fell in the dozen years following the Great Crash.³ The reaction in 2008 was so strong that some are even wondering what role there will be for markets. I was invited to address a conference in the EU Parliament last November on the topic 'Capitalism: Quo Vadis?', where I apologized to the international audience that the topic was posed in a dead European language because the answer to this question is not going to be determined by the west alone. The problems we have been addressing emerged in the west and have affected the rest. However, the answers will not come, solely from the west, and may even come primarily from the south and the east.

W[h]ither Capitalism?

At that conference I suggested that the best literal translation was 'Whither capitalism?', but a freer and more appropriate definition would be 'Wither capitalism?' In answer to the question, 'Capitalism – quo vadis?' three broad answers have been propounded. Some have said 'nowhere', some have said 'everywhere' and others have suggested that capitalism has a vital but defined role within a larger ethical order. During the 1930s, statist of the right and anarchists of the left said that capitalism had nowhere to

¹ This essay draws heavily on a presentation made as a guest of honour at the International Association of Human Values Conference in the EU Parliament in November 2008 ('Capitalism: Quo Vadis?'), a keynote address to the Future of Financial Regulation, a conference held to celebrate the 250th anniversary of the publication of 'A Theory of Moral Sentiments' in April 2009 ('Adam Smith's Dinner') and a public lecture at the United Nations in October 2009 ('Adam Smith's lost legacy: Ethics and Finance')

² Eric Hobsbawm is one who sees the comparison between the nonsense of the former USSR that you could plan everything and the equally nonsensical western notion that you could leave it all unregulated. See E Hobsbawm, *The Age of Extremes: A History of the World, 1914-1991* (New York, Pantheon Books, 1994).

³ Of all the 1929 democracies only the US, UK, Canada, Australia, New Zealand, Ireland, Switzerland, Sweden, Chile and Venezuela survived to 1941.

go. It was left to the American social democrats, in the end, to save capitalism from itself. In the 1970s, the statist of the left said that capitalism had nowhere to go. However, the anarchists of the right saw it as going everywhere; in fact, some of them started to say how superior markets were to democracy. The social democrats were the ones who saw capitalism playing a vital role in a larger order – with clear spaces for both the democracy of the dollar and the democracy of the vote. Some also recognized the need to police the boundary lest those with dollars buy votes or government action (a common form of ‘public private partnership’ that some call ‘corruption’). From 1980 to 2008, the ‘everywhere’ option seemed to be very popular, and it’s interesting how a number of extremists from the left became extremists for the right. A couple of the quite famous ones have decided to start moving backwards: it could well be that they are third time lucky. Yet I suggest we seek counsel elsewhere, and look to the role of values to save capitalism from itself a second time, and also to let us all glean a better understanding of the proper place of capitalism. I was profoundly unimpressed in 1989 that Francis Fukuyama should without irony herald the failure of the last ideology which proclaimed the end of history only to make a similar claim for his own. At the time, some of us had noticed a few problems with capitalism, and it is a pity that the decision by Gorbachev to end the cold war and to attempt gradual change towards more liberal democratic models led us to ignore those clear problems. I maintained then that there would be a role for markets, and that the extremism of statist or anarchists of the left or right had been a large part of the political and economic upheavals of the twentieth century, offering no prospects for solving problems in the twenty-first century. We should recognize the dynamic power of markets, which allow us to trade what we have for what we would prefer, but also recognise that this is one element in an effective order that serves the interests of the community.

Adam Smith’s Dinner and the Missing Variable

Adam Smith famously said:

‘It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own self-interest.’⁴

We might equally say that

it is not from the malevolence of the mortgage broker who writes the NINJA loan, or the ratings agency that anoints it AAA. It is not the malevolence of the arms manufacturer that invents the cluster bomb or the polluter who steams the planet. It is, rather, from their regard to their own self-interest.

Self-interest is an important motivation, but there are some other critical variables or preconditions determining whether self interest puts food on our plantation timber table, or cluster bombs in an overheated and flood prone backyard that has been repossessed by a zombie bank. The key questions is: what are those other variables, and why and how has their variation dealt so much damage so quickly? Or to put it another way – in what might the market be ‘embedded’ so as to deliver the former rather than the latter.

As many are aware, this is the 250th anniversary of *The Theory of Moral Sentiments*,⁵ the work Adam Smith regarded as his most important, and which provided the essential grounding for his *Wealth of Nations*. The former is now seen primarily to concern moral philosophy and the latter economics, so that some might say moral philosophy or ethics is prior to and more important than economics, and constitutes the relevant variable. But Smith would not have said that. He and other contemporaries lived before the separation of disciplines and, like Bentham, Smith would have seen little point in separating the modern disciplines of law, ethics, politics and economics, whose separate formation post-dates their work and

⁴ A Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Oxford, Oxford University Press, 1976 [1776]) 26. Note that, like most eighteenth century enlightenment gentlemen, the largely right-less members of households (wives and servants) do not figure in the equation.

⁵ A Smith, *Theory of Moral Sentiments* (Oxford, Oxford University Press, 1976 [1759]).

their insights. Two and a half centuries later, with the modern separation of disciplines now so broad, what might we say about Smith's missing variable?

Smith's eighteenth century petit bourgeoisie did business with regard to their own self-interest (rather than, say, their customers' interest or the greater good), but precisely what self-interest signified to them – and to him – can only be understood from an overarching view of the specific social and institutional landscape in which they found themselves (a society in which the sentiments of each and recognition of the sentiments of others gave rise to a form of ethics and justice. This kind of overarching understanding – or the attempt at it – seems by and large to have been missing from contemporary academic debate. The study of institutions, their problems and solutions, what they are and what they mean, is divided into strongly theorised but limited discipline-specific fields, which can easily aggravate any nascent contemporary misunderstanding of the thrust of Smith's observation. Each discipline provides vital yet severely limited insights into the social and institutional settings in which putatively self-interested agents go about their everyday business. Our missing variable concerns the institutional settings in which people live, and in which they interact with one another – sometimes, as in Smith's example, through the medium of markets. I am not suggesting that we return to Smith's philosophy and the answers it generated in a lowlands urban concept of Scottish society with a distant and limited crown, no unions or large commercial enterprises (of which he in any case disapproved). Yet how do we best conceive of and govern these intermediary institutions, given the current interdisciplinary (and intra-disciplinary) proliferation of theoretical approaches to institutional governance? The question is especially pressing if our aims include ameliorating and preventing the kinds of system-wide failures – the current world economic crisis furnishes a vivid example – that have occasionally spilled over and devastated butchers, brewers, bakers and their customers alike.

Institutional Governance and Disciplinary Compartmentalisation

Despite the western emphasis on rational individual agency, we live our lives with other human beings, largely in and through the institutions into which we were born and educated, and in which we work, think, feel, play, procreate and age. Even when we try to act like the idealised rational individuals we are sometimes assumed to be, our lives are played out in an environment characterised by powerful institutions capable of shaping and influencing our deepest motives and most important deliberative decisions. Indeed, institutions and their governance play a significant part in many, if not most or all, of our most pressing collective problems. Institutions are also almost invariably a key part of solutions to these problems, whether the institutions be non-government organisations (NGOs), corporations, industry groups, regulators, government agencies, regional bodies or international agencies. The importance of good institutional governance is recognised by many disciplines which might make a contribution to institutional governance and reform. The problem is not that it is ignored: the problem is that each discipline has a strongly theorised but limited conception of institutions, which colours and structures their view of the nature of institutional problems and the best means for addressing them. For example, lawyers look at institutions and see sets of formal norms, ethicists see informal norms and the values the institution claims to further, economists see incentives and disincentives, political scientists see power relations, social psychologists see complex webs of interpersonal and group relationships, and management theorists see structures and systems. Accordingly, the problems are seen in the deficiency of laws, ethical standards, incentives, power relations, systems and so on, and the solutions are seen as lying in remedying those specific deficiencies.

All these partial insights into institutions and their problems are important and any solution that ignores them is likely to fail. However, as proffered solutions tend to be developed from only one disciplinary perspective, they are necessarily limited, perhaps over-emphasising legislative solutions or the impact of economic incentives. As indicated above, this was not a problem when Smith and Bentham were writing. However, the explosion of literature within each of the relevant disciplines means that we need strong interdisciplinary teams with mutual understanding and respect for what their disciplines can contribute. Those who study governance generally engage in a further specialisation in the kinds of institution whose

governance they research. Many concentrate on government institutions, but others focus on corporations, professions, NGOs or international organisations, among others. However, many of the most intractable governance problems occur when inadequacies at one level of governance are reinforced and exacerbated by inadequacies at other levels. This has always been the case, for instance, in issues of peace and security where the inadequacies of global governance are exposed by governance failures within states. This is paradigmatically the case in the response to climate change, where governance issues at global, national and corporate levels contribute to the problem and make finding solutions difficult. It is also most certainly the case with the 2008 'GFC', where problems of global, regional, national, corporate and professional governance produced the greatest set of interlocking governance failures since the 1930s with its threatened but prevented implosion that may yet eventuate if we go through a second round.

Multiple Governance Failures and Globalisation

One point that has become very clear is that the crisis has been the result of multiple and reinforcing governance failures. Globalisation has certainly been a factor the genesis and spread of the GFC. If globalisation involves the flow of people, ideas, goods and money, the last mentioned has grown most rapidly – indeed well in excess of the flow of goods and investment that it is supposed to support. Employees in developed countries have entrusted the comfort of their post-retirement lives to financial intermediaries. Developing countries have entrusted their enormous and growing surpluses to western banks and other financial intermediaries. Some have been pressed by western run multi-laterals to entrust the proceeds of extractive industries in Wall Street and other financial centres on the basis that it was less likely to be eroded by corruption. The amounts entrusted to such intermediaries in the US and elsewhere on the basis that funds would be invested on a secure and conservative basis were unprecedented. It now appears that entrusted powers were abused.

Many within financial intermediaries pursued strategies that focused on the maximization of fees and short-term profits. The ratings practices were scandalous and incredibly insulting to well run businesses and governments whose default risk was, in reality, far less than one hundred percent-plus non-recourse mortgages provided to NINJA borrowers ('No Income, No Job, No Assets'). The fact that risk models were based on the probabilities of individual defaults and ignored the possibility of an overall decline in property markets is less of an excuse than an indictment. Once such ratings could be secured, the signing up of mortgagees, the packaging of those loans, their rating and their sale to local citizens and foreigners resembles a well oiled 'corruption system'. Even though these intermediaries did not see themselves as corrupt, several parties were maximizing their fees while squandering profits at the expense of those who entrusted them with their funds. The unedifying subsequent sharp shift from greed to blind panic adds to the contempt seen in talk radio and readers letters across the world. The damage that was subsequently inflicted on those engaged in the production and distribution of goods and services has caused shock and anger and raises profound questions not just about the future of financial regulation but many elements of global and national financial systems.

The pathways for transferring funds to where they can most usefully and profitably be deployed became the pathways through which the financial contagion has spread. It was like a financial influenza pandemic which has jumped from another species to humans and has spread toxic products through the pathways of our interconnected world. And just like an influenza pandemic, it is capable of infecting perfectly healthy institutions. Alternatively, one might draw the analogy that some terrorists are so completely committed to an extreme version of a widely shared religion that they are not constrained by normal rules, and are contemptuous of the more moderate faith held by a majority of their co-religionists. Substitute extreme fundamentalist market theory for extreme fundamentalist religion and the metaphor of financial terrorism may stick. The financial terrorists may not believe in an afterlife with 60 virgins but \$218m can buy a lot of whatever you fancy in this life. I am not suggesting that Guantanamo be kept open for a new batch of the 'worst of the worst' but I do not rule out the possibility that a condition of continuing to lend money is that we will demand an explanation of how so much of the money lent was squandered, who squandered

it, what we have done to ensure it does not happen again, and what we have done to punish those responsible.

The inability of any one discipline to find adequate answers and the multiple reinforcing governance failures such as those that gestated the current global economic malaise might tempt us to argue for a radical change of the kind we had in the 1930s, in which many rejected markets, democracies or both; or the kind of extreme and rapid reversal that cut the Russian and several other economies by half. I don't think that we should discard markets or democracy, but we should recognize and address the institutional problems in each, and the ways they interact. I would argue that we should question every assumption on which our theories are based and on which they are separated. If not, a fresh round of enormous policy mistakes may be made with GFC round 2 or GCC (Global Carbon Crisis⁶) Round 1. Failure could produce desperation, extremism and, in more countries than one might imagine, disorder and even revolutionary rejection of markets or democracy. The stakes are especially high because of huge mistakes made over the last ten years on the basis of a smug and misguided belief that a 'Great Moderation' had been achieved through well-crafted and effective global governance and the skilful deployment of appropriate institutional power.

The Missing Variable: Equity, Trust and Fiduciary Duty?

One popular way of conceiving the missing variable is to use the terminology of trust. A trust involves a fiduciary relationship between a trustee who holds property on behalf of one or more beneficiaries, and who has a fiduciary duty to exercise his or her powers over that property in the interests of the beneficiaries. The trustees and beneficiaries may never have met, and the latter may not even know of the relationship. The relationship may be set up by agreement between the former owner of the property, or may be implied because of the position or conduct of the trustee. There can be multiple beneficiaries, whether named or in classes. There can also be multiple trustees, or the trustee may be a corporation or an institution. This approach became very influential in political theory as the enlightenment reversed the polarities of the relationship of sovereign and subject to make states responsible to citizens, and required them to justify the exercise of state power to the citizens who were the beneficiaries of the new implied trust. A breach of that implied trust would give the subjects or citizens a right to rebel. With the coming of elections, changeovers could be achieved with less disruption but it was, and still is, common to see the elected representatives holding power on trust for those who have conferred it. The terminology of trust also influences the way that administrative law imposes various constraints on the exercise of governmental discretion. This approach has been even more central in understanding the relationship between directors and shareholders in corporate law. For example, in the aftermath of the corporate and political scandals in Western Australia that tarnished and then came to define the 'WA Inc' of the 1980s, Professor (now Justice) Paul Finn re-emphasised equity and saw it as a way of understanding the relationship between state and citizen as well as director and shareholder. Trust-based thinking also influences Transparency International's definition of corruption as the abuse of entrusted power for private gain. The trust approach is thus very fruitful and may be perfectly satisfactory for many. It is particularly useful in looking at the ethical duties of government and corporate officials. However, it remains rooted in the model of an interpersonal relationship, and in this regard may fail to capture the institutional character of governments and corporations.

The Missing Variable: An Institutional Approach

For the last 19 years, I have taken an institutionalist approach⁷ in which I have argued that government and corporate institutions need to justify themselves to the communities in which they operate for a number of reasons, including:

⁶ See discussion of a potential global carbon crisis below

⁷ See, in particular, C Sampford, 'Law, Institutions and the Public Private Divide' (Keynote at 1990 ALTA conference later published in *20 Federal Law Review* 185 (1992)); C Sampford and N Preston *Encouraging Ethics and Challenging Corruption: Public Sector Ethics in Theory and Practice* (Federation Press, Sydney, 2002).

1. The various privileges they are accorded – most notably, limited liability of joint stock companies (banks also have the ability to create credit and access to central bank ‘lender of last resort’ facilities).
2. Various benefits that are provided – in particular, bank guarantees and, as we have seen, the bailing out of corporations that are ‘too big to fail’, as well as a general expectation (for some an obligation) to use governmental powers to prevent some of the worst problems afflicting economies.
3. The legal protection of property rights that are backed up by state power.

The reasons why these privileges, benefits and protections are provided is not for the benefit of government agencies and corporations, but because doing so is believed to benefit the community as a whole. In general terms we allow the creation of joint stock companies because they are seen as increasing the likelihood that we will have dinner on our table (as well as the many other things that people wanted then and the more things they want now). However, there is another and in my opinion decisive reason why governments, corporations, and indeed all institutions need to justify themselves to the communities in which they operate. All institutions concentrate power, people and resources to achieve certain publicly stated goals which are, or are seen to be, of benefit to the relevant community. However, that concentration of power, people and resources could be used for other purposes that might harm that same community. Police forces and the armed services are supposed to protect citizens but can use their coercive force to secure bribes, to terrorize inhabitants or even to seize state power. Banks and other financial institutions concentrate the resources of their shareholders, depositors and others who entrust them with their money. These resources are supposed to ensure liquidity for those who engage in the provisions of goods and services to others. Yet those resources can be used in transactions that generate very high fees for the financial intermediaries at the same time as they create great risk for those who have entrusted their money to them.

For anarchists, the dangers are just too great, but most of us are prepared to take a risk. The American revolutionaries considered this very carefully. Governments are instituted to support the ‘inalienable rights to life, liberty and the pursuit of happiness’, but they could turn against the people they were supposed to benefit, justifying revolution and the establishment of governments that could perform the relevant function (or in my terms, justify themselves). They did not decide to abandon the idea of government because government power had been abused. However, they wanted to reduce the risk of future abuse by creating a system of ‘checks and balances’ that provided a form of ‘risk management’.

While Adam Smith saw virtue in competition, he certainly recognized the dangers of the abuse of economic power in his warnings about combinations of merchants and large mercantilist corporations. Over the intervening two and a half centuries we have seen many cases where governmental and corporate power have been abused and our ‘risk management systems’ have been improved. The three responses typically tried are legal regulation, explicit ethical standard setting, and institutional reform. I have long argued that the three are relatively ineffective if tried on their own, but can be highly effective if used in combination and directed towards making it more likely that institutions will live up to the public justifications for the powers and privileges they exercise. I have argued that ethical standard setting provides the most effective means of integrating the three by encapsulating the core of explicit ethical standard setting, the principled basis of laws and the ultimate criteria for judging whether institutional reforms have been effective.

This ‘institutional’ approach bringing together ethical standard setting, legal regulation and institutional design will need to be implemented at a number of levels – at the corporate level (with individual financial institutions, regulators and other players), at in co-ordinating regulators and oversight bodies into

‘financial integrity systems’ at national, global and, in some cases, regional⁸ levels. I will comment briefly on the first level and then discuss the application of the idea of national integrity systems to finance at the global level.

Integrity systems for individual firms

I have long argued⁹ for a values-based approach to governance of institutions – be they corporations,¹⁰ government agencies¹¹ or professional groups.¹² It uses a form of ‘institutional ethics’ to integrate ethical standard setting, legal regulation and institutional design and utilize the insights of the four main governance disciplines in looking for potential norms. This approach starts with Peter Singer’s basic ethical question – how are we to live?¹³ Answering that question involves asking yourself hard questions about your values, give honest and public answers, and trying to live by those answers. If you do, you have integrity in the sense you are true to your values, and true to yourself. In fact, if you don’t live up to the answers you give, the first person you cheat is yourself.

Institutional ethics applies the same approach to institutions. It involves an institution asking hard questions its value and values, giving honest and public answers and living by them. Doing so for an institution is more complex than for an individual but it is both possible and necessary. This starts with the vital questions that must be asked of any institution or organisation: what is it for? Why should it exist? What justifies the organization to the community in which it operates given that the community generally provides privileges? Why is the community within which it operates better for the existence of the government/corporation etcetera? Asking those questions involves an institutional and collective effort under its own formal and informal constitutional processes (including getting acceptance from relevant outsiders – including shareholders and or relevant regulators).

An organisation has integrity if it lives by its answers. However, it does so in a different way. It cannot merely be a personal commitment but an institutional commitment that involves creating mechanisms which make it more likely that the organisation keeps to the values it has publicly declared and to which it is publicly committed. These mechanisms are collectively called an ‘integrity system.’ Leaders of financial institutions would do well to commence this process and consider the justification for their existence, for the concentration of resources within them and the special privileges accorded them. Why is the community better off for their existence? Is it better off? These are questions that should always be asked – the difference is that there is now a demand for answers from outside as well as a need to provide them internally.

I will not rehearse this complex process but I will reprise a thought that a common room conversation generated twenty years ago when we were going through a property boom as investors burnt by the stock market crash went searching for what they thought was safety in real estate. I had a post-doctoral fellowship at Monash University and a new colleague introduced himself as the first person appointed to teach Banking Law in the Faculty. I enunciated a view of banking and banking law.

⁸ Regional level financial integrity systems are important in Europe and their further development may be the key to solving the diverse problems of countries with financial systems in difficulties like Ireland, Latvia, Iceland and countries with recessional problems like Germany.

⁹ See note 5 above.

¹⁰ C Sampford and DAR Wood, ‘The Future of Business Ethics: Legal Regulation, Ethical Standard Setting and Institutional Design’ 1 *Griffith Law Review* 56 (1992).

¹¹ C Sampford, ‘Institutionalising Public Sector Ethics’ in N Preston (ed) *Ethics for the Public Sector: Education and Training* (Federation Press, Sydney, 1994).

¹² C Sampford and C Parker, ‘Legal Ethics: Legal Regulation, Ethical Standard Setting and Institutional Design’ in Parker and Sampford (eds) *Legal Ethics and Legal Practice: Contemporary Issues* (Oxford University Press, Oxford, 1995).

¹³ P Singer, *How Are We to Live? Ethics in an Age of Self-Interest* (Text Publishing, Melbourne, 1993).

‘The first principle of banking is to ensure that as much money passes through your hands as many times as possible ensuring that a little bit sticks each time. The first principle of banking law is that what sticks is yours.’ A decade later, I added: ‘The first principle of banking ethics is that the transaction and the stickiness is justified as a service to the community to which banking claims to be a service industry.’ Paul Krugman has pointed out that financial services now account for 8% of the US economy – up from 4% half a century ago.¹⁴ Does this mean that it is doing twice as much or does it mean that they are half as efficient – or just that a lot more client’s money is sticking to their hands – and in ways that do not serve the interests of the economy and the community?

National Integrity Systems and Financial Integrity

At the national level, various ways of integrating legal regulation, ethical standard setting and/or institutional reform have been tried. Twenty years ago, the Hong Kong model (a strong law and a powerful agency) was the general model for fighting corruption. However, when Queensland sought to address the endemic corruption problems that had plagued it, they did not opt for that model. Since then, preference has shifted to ‘national integrity systems’ (NIS) in which several institutions, agencies, laws and codes simultaneously seek to promote ‘integrity’ and limit corruption – to increase the probability that entrusted powers will be used for its publicly justified and democratically endorsed ends and reduce the likelihood that those powers are abused. The choice of the term ‘integrity system’ rather than ‘anti-corruption’ system was inspired. Corruption (the abuse of entrusted power for personal gain) is a derivative concept and a derivative goal. One cannot know what an abuse is without knowing what the legitimate uses of those powers are. Integrity (the use of entrusted power for publicly justified ends) is primary. We want effective institutions that deliver a sufficient proportion of their promises. If all we just wanted to avoid institutional corruption that goal could be achieved in theory by not having institutions of the offending type at all, and in practice from anti-corruption practices that prevented such institutions from wielding any power. But the potential for corruption is built into all institutions because of the dynamics of collective action and agency. The reason why we create and support governments, joint stock companies – and international NGOs – is because so often more can be achieved collectively than individually with the pooling of people power and resources for shared goals.

However, this pooling of power opens the possibility that institutional leaders may turn that entrusted power to their own benefit or use against their citizens, stockholders, bondholders and employees. While it is not true that all power corrupts, it has to be recognized that it will not only attract those who wish to exercise it for its publicly justified purpose but also those who wish to use it for their own purposes. Hence anti-corruption agencies still have a place, but it is a place within a system that is primarily directed to channelling institutions into using their powers in the ways that they claim and by which they justify their existence. I would argue that this approach is very apt for application and we should see ourselves creating and refining national and international financial integrity systems. There are already multiple agencies from government, corporate and NGO sectors with mutually complementary and supportive institutional goals. In any case, most public officials and company directors are more than happy to engage in such justification. They genuinely believe that their activities do make society better off. Very few see themselves as social parasites benefitting at the expense of the community.

While there is a need for immediate action to limit the fall out to a ‘mere’ global recession, serious global research is required to understand these interlocking and mutually reinforcing problems and then totally rethink the responses needed. This will involve rethinking the nature and function of corporations, financial intermediaries and the capital markets in which they are nested. This includes what is now called “smart regulation” – designing and integrating rules, principles and norms to enhance security while simultaneously ensuring that sustainable innovation will not be compromised. This task requires, in turn, an integrated approach that transcends the limited solutions suggested by particular disciplines, and which looks to the ‘integrity system’ approach that was so successful in post-Fitzgerald Queensland. Such

¹⁴ P Krugman, ‘The Market Mystique’ *The New York Times* (26.3.2009) 29.

integrity systems involve ethical standard setting, economic incentives, organizational structures, and the professionalism of those involved. The provision of oversight by lawyers, accountants and journalists is also vital. Moreover, the reality of global capital flows and the nature of the problems involved means that the search for an equitable and sustainable solution cannot be undertaken by one nation using or solved by using the conceptual frameworks privileged by one disciplinary perspective. What is required is never just a new law but a reformed and effective 'global financial integrity system'. Not for the first time, capitalism needs to be saved from itself, so that it can live up to its claims to advance human wellbeing rather than live down to the deficits which its critics have long claimed lie at its heart.

The best and most complete contemporary solution to Smith's missing variable thus lies in establishing a new global financial integrity system. What will this look like? A proper answer to that question would be better following rather than in advance of a 'Global Financial Integrity Systems Assessment' based on the methodology we pioneered with Transparency International¹⁵. Luther nailed 95 theses to the door of a German church. I will not be so ambitious, but here are a dozen to begin with:

1. The explicit recognition of power in the market economy, including:
 - a. Concentration of political and social power, people and resources within organisations.
 - b. The inevitabilities of asymmetries in knowledge and the fact that the exploitation of these is a feature of all market and political systems and the basis of much profit making.
 - c. The inevitability of agency problems that mean that markets cannot operate unregulated – and that those who have power and asymmetric knowledge may well propose unregulated markets to make it easier to exercise their power and asymmetric knowledge.
2. Recognition of ideology and recognition of self-interest in public debates, including:
 - a. Recognition of the self-interest of financiers arguing that privatisation and public private partnerships are necessary and desirable.
 - b. The existence of ideology – political, economic, social, moral – within debates about governance of financial markets and the tendency to make self-serving comparisons between ideologies in which the ideal version of one's preferred ideology is compared with actualized versions of others.
 - c. Questioning how efficient markets theory ever got going and the ideological controls on appointments in so many economics faculties, including the role of think tanks in pressing the interests of their donors. Economists especially must recognize that their insights are partial and limited and can only be useful in conjunction with other disciplinary perspectives.
3. Organisations should publicly justify themselves to the communities in which they operate, including:
 - a. Asking deep questions about their values, giving honest and public answers and demonstrably exemplifying them.
 - b. Being transparent.
 - c. Taking public responsibility for failures as well as celebrating successes.
4. Repudiating the externalisation of costs and risks onto others.
5. Recognising the dangers of executives enjoying a large share of upside and limited downside risk – an agency problem that has materialized in many financial institutions.
6. Ratings are not done by New York firms and must be dissociated from ideology.
7. International financial system will not be a means for supporting domestic illegality, meaning specifically:

¹⁵ The most recent statement of this is found in my conference overview paper commissioned by Transparency International for the 13th International Anti-Corruption Conference in Athens last year. www.13iacc.org

- a. Corporations not paying their taxes¹⁶.
 - i. This is a quid pro quo for bailouts that save the system. We cannot expect ordinary citizens to bail out financial corporations and not expect those companies that remain profitable to avoid their responsibilities.
 - ii. Those who are still profitable should be glad that they are and willing to take on their responsibilities.¹⁷
 - iii. But we should implement simpler taxes – basic income and flat taxes.
 - b. Hiding of dictators' money.
 - c. Lending to dictators other than secured on assets that are built with the loans.
 - d. Odious debt and toxic debt.
8. International financial system will have to take into account climate change and other significant externalized costs.
9. The immediate response has to be national, or rather internationally co-ordinated but nationally based. However, the new system will have to be truly international – because it is going to depend on some countries continuing to lend to others.
10. The response will have to include the creditor nations whose continued support is critical. They are going to be the ones who do the bailing out. If debtor nations like the USA have a place at the table, so do other debtor nations. The USA would not want its creditors to give the same weighting to creditor nations over debtor nations as in International Monetary Fund (IMF) deliberations. In recognizing the reasonableness of that position, they should be promoters of a change in the IMF.
11. We must recognize that American power is going to wane more quickly than had been thought. American hyper-power never existed and attempts to preserve it were consequently doomed to failure.
 - a. Ten years ago, the USA possessed huge reserves of both soft power and hard power.
 - b. It squandered the former and overestimated latter, leading to a weakening of its military and financial power and an exposure of those weaknesses.
 It is now seeking to boost both but must do so as a leader whom others are willing to follow.
12. We may need the global equivalent of a truth and reconciliation commission. The USA and other liberal democracies may need to give up some of those who appear to be corporate criminals to that process as a way of indicating that their priority is fixing the problems rather than protecting the perpetrators. This may be an essential condition for restoring confidence among those whose continued and possibly increasing loans will be necessary.¹⁸ The alternative might be handing them over for prosecution.

Financial and Human Security Issues: From Climate Change to Capital Flows

In the current global crisis, activities to combat climate change may or may not be part of the stimulus packages introduced by some countries. Just as important may be the warning signals it sends for carbon

¹⁶ Tax avoidance is important for a number of reasons. It detracts from the revenue available to states to look after their people and bail out the system. It is also quite likely that the attitudes to tax avoidance within law firms helped establish the culture in which regulatory avoidance came to be legitimated in large law firms.

¹⁷ I have never had much sympathy with those who complained of having 'taxation problems'. The real problems are income problems!

¹⁸ At other times, the sacrifice of a few heads to the tumbrils might be seen as a good way of assuaging the anger of developing country creditors whose entrusted funds were squandered. The insistence of a fair trial is a reasonable modern caveat – made more difficult because of the treatment of those at Guantanamo.

trading schemes. For most of this decade there has been general agreement that we need to send price signals to those engaging in unsustainable activity and most have favoured carbon trading over a carbon tax. I have been quite sceptical of carbon trading ever since I was invited to speak on this matter for a World Council of Churches colloquium in 2000. As soon as I started to see merchant banks salivating over the money to be made on the carbon market I was sure that it was a bad idea. Who would now suggest that those who destroyed more than five trillion dollars of value (and counting) should be given the role of building the carbon market that is supposed to save the planet? Beyond climate change, human security goes to a range of domestic governance issues, but it also goes to the issue of the distribution of capital flows.

When I was on a World Bank Governance mission to East Timor, I was surprised that most of the foreign aid bodies thought that the spike in proceeds of East Timorese oil government should be invested in New York. There were some short term reasons for this – the capacity of the economy to absorb large scale infrastructure investment, the uncertainty of what the best infrastructure would be, the lack of a developed integrity system to ensure that the funds were used for the purposes intended rather than corruptly appropriated, or spent on pet projects that had not been properly examined and pork barrelling. However, once those impediments had been addressed, East Timor should have been an entirely appropriate place for East Timor to invest in. Traditionally the wealthiest economies have generated a lot of capital and have exported it. This is because the greatest growth and the greatest opportunities have occurred in developing countries.¹⁹ In the mean time, putting all their money into one country, especially one with the known global debt problems at the time, should have seemed narrow. Investments might well have been made in developing countries that were clean and which were ahead of East Timor in the above desiderata.²⁰ I was glad to discover, however, that most of East Timor's sovereign wealth fund was invested in fixed interest securities, so no harm was done to that particular sovereign wealth fund of a poor country.

If globalization involves the flow of people, ideas, goods and money, the last has grown most rapidly – indeed well in excess of the flow of goods and investment that it is supposed to support. Developing countries have entrusted their enormous and growing surpluses in western banks and other financial intermediaries. Some – such as East Timor – have been pressed by western run multi-laterals to entrust the proceeds of extractive industries in Wall Street on the basis that it was less likely to be eroded by corruption. The amounts entrusted to such intermediaries in the US and elsewhere on the basis that they would be invested on a secure and conservative basis were unprecedented. As I have already observed, it now appears that entrusted powers over vast sums of money were abused for personal gain.

This does not mean that banks should not have been rescued. The fact that they were poorly run is not the point. If they had been well run, they would not need to be rescued. Rescues are instigated to protect the wider economy, confidence and depositors who were not accepting suspiciously high rates – while seeking to ensure that the owners and managers of such banks remain as exposed as possible to the consequences of their mistakes. Nor does this mean that all participants acted unethically or illegally. However, if confidence in the international financial system is to be restored in the long term, and if the proceeds of developing country surpluses and western superannuation are to continue to be entrusted with intermediaries for investment in the globalized economy – thereby supporting sustainable globalization rather than undermining it, then, this can only happen if there is a full investigation of what went wrong and options for the establishment of adequate financial integrity systems are debated, selected and implemented as part of the Global Integrity System. Such an investigation will have to include members of developing as well as developed countries and be supported by the work of international researchers, NGOs and international organizations. In this process the Equator Principles, the UN Global Compact, the UN Principles of Responsible Investment will need to be reconsidered and implemented.

¹⁹ This has since been pointed out by the President of the Chinese Central Bank.

²⁰ This would have had the advantage of focussing on businesses whose work might be applicable in East Timor.

In reforming the international financial system, we should set the goal of ensuring that those who are entrusted with investing funds for others do not abuse that entrusted power to increase their wealth at the expense of those for whom they invest. At the same time, we should set the international banking system the goal of establishing a regime that is sufficiently transparent so that no rational corrupt official or tax avoider would put his money in an offshore bank. This author has long argued that this is the single most important contribution that developed nations can make to the reduction of corruption in developing nations. While some developed nations had resisted such a goal, 9/11 has stimulated the development of relevant tools.

Conclusion

Markets in which self interested exchanges of what we have for what we prefer are extremely powerful. But their ability to deliver benefits for the communities in which they operate are dependent on other variables of the communities in which markets could be said to be 'embedded.' Adam Smith would have emphasised 'moral sentiments' as the key variable. This paper has argued that the key variable should not be seen as ethics but a 'global financial integrity system' in which ethics plays a key role in 'values based governance.' The author takes an institutionalist approach in which institutions are required to justify themselves to the community of which they are a part. That justification is in part because of the special privileges granted to financial institutions in limited liability. The reality of global capital flows and the nature of the problems involved means that the search for an equitable and sustainable solution cannot be undertaken by one nation using or solved by using the conceptual frameworks privileged by one disciplinary perspective. What is required is never just a new law but a reformed and effective 'global financial integrity system'. Not for the first time, capitalism needs to be saved from itself so that it can live up to its claims to advance human wellbeing rather than live down to the defects which its critics have long claimed lie at its heart. If confidence in the international financial system is to be restored in the long term, and if the proceeds of developing country surpluses and western superannuation are to continue to be entrusted with intermediaries for investment in the globalized economy (thereby supporting sustainable globalization rather than undermining it) there must be a full investigation of what went wrong. Subsequently, options for the establishment of adequate financial integrity systems must be debated, selected and implemented as part of the Global Integrity System. Such an investigation will have to include members of developing as well as developed countries and be supported by the work of international researchers, NGOs and international organizations. In this process the Equator Principles, the UN Global Compact, the UN Principles of Responsible Investment will need to be reconsidered and implemented. In reforming the international financial system, we should set the goal of ensuring that those who are entrusted with investing funds for others do not abuse that entrusted power to increase their wealth at the expense of those for whom they invest. If so, we can, like Adam Smith, enjoy our dinner – and get a good night's sleep.