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The Public Good and Capitalism

Introduction

Does anything shock you about business these days? Do the eye watering bonuses paid to financial workers, followed by the mind boggling sums to bail out banks and followed by massive fines to banks for money laundering, misselling and manipulation of interest rates bother you? Few protest. Our capacity for outrage must have been dulled. There is a sense of resigned acceptance that there is little anyone can do about it or even that anyone really cares. Such acceptance is tempered with a growing cynicism and lack of trust in finance. In the UK journalists were found to have hacked the private phone conversations of celebrities, politicians and members of the public. Last year Toyota settled $1.3 billion to resolve a criminal investigation into safety. Toyota admitted it misled United States consumers by concealing and making deceptive statements over safety issues that caused cars to accelerate as drivers tried to slow them down. We must accept that mistakes happen and that complex technical equipment can have safety defects. We should not accept serious ethical failure.

The latest revelations about Volkswagen and cheating emissions tests are maybe just one more example of serious ethical failure in a series of isolated incidents. Perhaps, however, these incidents are symptomatic of a systemic problem. I do not know but there is no systemic mechanism to prevent ethical failure. Such a mechanism is required; this paper sets out what that mechanism could be and how it could work. What is needed is for businesses to consider how they contribute to the 'public good'.

I first developed this idea in 2011. The seemingly regular news of corporate wrongdoing and dysfunctional behaviour since then make me surer that what is needed is to create a structure where companies are encouraged to contribute to the public good. I raised the idea again at CASS Business School recently and it gained some support. This could be the most simple yet powerful change that regulators could bring about.

The Background

During the years of industrial unrest in 1970's Britain, business was branded by many as a villain. A widespread view then emerged in the 1980s that free markets were a good thing and that the less business and finance were regulated the better it would be for society as a whole. A financial service was liberated and became the engine of growth. Economic prosperity increased for most people but the gap between rich and poor widened dramatically. Then came the credit crunch. We still do not know whether the financial crisis caused just a nasty but relatively short blip in economic growth or something much worse. It has, however, already claimed many innocent victims across society including elderly people trying to live off the interest from savings.

It is now clear that an unfettered market may not be the best one. As happened in the early 2000s after Enron collapsed, there is more talk now about ethics. But, apart from saying there was too much greed, it has been difficult to point to any particular ethical failing, except where we know laws were broken. But we know that following the rules does not necessarily equate with good ethics. In fact we have seen many examples where practices which failed the public acceptability test were met with the defence that 'we were following the rules'. Unfortunately gaming-the-rules rather than playing-by-them became common.

Capitalism cannot exist without society and

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society wants or needs capitalism to raise standards of well-being. In an ideal world there would be a yin-yang relationship between capitalism and society, where capitalism benefits society and society enables responsible capitalism to flourish. Unfortunately some people in business seem to see society as, in effect, capitalism's prey to be devoured. This fits well with the Western 'we want it now' culture. The idea of a hunter who eats what s/he kills makes a poor metaphor for business – it corrodes trust; a better one is of a farmer who grows food and husbands livestock while looking after the environment. This approach builds trust and that is good for business and for society, and it necessitates a long term approach.

Rules and Regulation

How could we make business leaders more like farmers. When something bad happens, the response of governments, indeed almost anyone in a position of authority, is to think about more rules. But having more rules is not the answer; the financial crisis exposed their limitations. People game rules. A compliance mind-set meant that people did not have to worry about whether something was right or wrong or even sensible. The shadow banking system, the massive build-up of debt and leverage may not have happened without the Basel framework creating the gaming opportunity. The US Community Re-Investment Act of 1977, which outlawed discrimination by banks against low-income households, was also an unwitting catalyst for the crisis. Same say too that financial reporting and auditing standards have become too rules-based. The accounting profession should again questioning the purpose of accounting and auditing, whether it is sufficient to comply with relevant technical standards or whether something more is needed to ensure that the profession of accountancy serves society as well as it could.

Principles ought to be more important than rules. But not everyone likes principles, they create ambiguity and a few people want to know what they can get away with. A principle such as 'substance over form' can seem too restrictive if there is the possibility that a court or disciplining body might say that a particular action was wrong after the event. People like certainty over what they can and cannot do. The less well intentioned are of course entirely comfortable with principles if they are never enforced, so it is necessary that people can be held to account for not upholding principles.

We may have reached a point where there are just too many laws and rules. We should try to return to a situation where there is more emphasis on common law where actions are interpreted according to precedent, principle and common sense rather than compliance.

Measuring Value

Adam Smith divided incomes into profit, wage, and rent. In profit-seeking behaviour, entities create value in a competitive environment by engaging in mutually beneficial transactions. This is the invisible hand which promotes the public good irrespective of the intention of the profit seekers. In rent-seeking, wealth is transferred from one party to another through the latter being able to benefit from special privileges conferred by favourable or ill conceived regulation. Such privilege might include benefits from monopoly or oligopoly, quota, licence, regulation and state support. Rent-seeking behaviour does not add value, nor does it serve the public good.

These days, because legislation and regulation are so entwined with business it is often hard to distinguish the two types of income. The fact remains though that rent-seeking is likely to feature wherever 'profits' are made that are higher than can be explained by competitive forces alone. This clearly applied to the profitability of the banking sector. How else can you explain global banking profits in 2006 of $788 billion, over $150 billion greater than oil, gas and coal? Global banking revenues were 6% of global GDP and its profits per employee were 26 times higher than the average of other industries. Such profitability was due in large part to market imperfections such as lack of competition, information asymmetry, and state guarantees to depositors. A shortcoming of our present reporting framework is that it does not distinguish profits which are earned from value creating behaviour in a competitive environment and transfers of wealth through rent seeking behaviour. Nor does it distinguish good costs from bad ones - there is no difference in accounting terms from the cost of necessary maintenance to keep the business sustainable and money spent on unnecessary expenditure. Markets tend to reward CEOs who cut costs suggesting a view that costs are there to be cut rather than essential to maintain long term value creating. The accountancy profession could do more to encourage better measures for value and changes in value and for reporting on value and for reporting on value creation.

There are problems with measures and measurement. One problem is with achieving appropriate precision. Valuation of hard to value items such as land during a recession or mortgage backed securities in a credit crunch cannot be precise yet financial statements do not convey that some valuations may be little better than a guess. Another problem is that any information derived from comparison with social or economic measures can be misleading or dangerous. This is because a measure turned into a target for policy will lose the information content that qualified it to play the role in the first place because people game it. This phenomenon is sometimes known as Goodhart's Law after the economist Charles Goodhart.

Take for example a Soviet-style factory tasked with producing as many nails as possible. It produced lots of tiny useless nails and, when given a target based on weight, producing a few very heavy nails. This might sound like an argument for free enterprise but the phenomenon is prevalent in market economies and especially in areas where governments want market forces to operate in a regulated environment. This includes banking and includes the health sector. The public sector is plagued with examples such as when hospital waiting lists became a target to be managed down; a hospital introduced a waiting list for going onto a waiting list. In banking, the Basel framework facilitated the shadow banking system and a dependency on credit ratings. E M Goldratt, in one of the few management accounting novels, The Goal, showed how seemingly sensible production targets could lead to bottlenecks and to bankruptcy.

New thinking is required. It is now widely recognised that a change in culture is needed and many people are aware of how difficult this is to bring about by regulation. Governments talk about society and citizenship, in terms that are difficult to define. But what if our company law or corporate governance framework introduced an explicit requirement for boards and companies to work for the public good? This could sit alongside other aims such as to make a profit.

The Public Good

The Golden Rule is found in most of the world's religions. It says 'do to others as you would have them do to you'. It is a good guide but does not

actually give any particular moral direction or steer. In general, most company and professional ethics frameworks and codes also do not give a clear ethical direction: they lack a moral compass. Even those which are expressed in terms of values rather than conduct leave much ambiguity. It is too simple to say simply 'do the right thing', but this is the essence of what we need.

I am not calling for a legislative requirement for companies to work for public good. I am suggesting, however, a requirement for companies to say how they contribute to the 'public good'. Everyone has a sense of the public good. Companies which demonstrate how they contribute to the public good should be rewarded by loyal shareholders and customers. There may be occasions when one person's sense of public good may be another person's idea of public bad but, if the principle was enforced by the court of public opinion, it could be effective. Any bad should be outweighed by the good – at least as far as society at any time might judge what 'good' is.

Adam Smith said that 'by pursuing his own interest a person frequently promotes the interest of society more effectually than when he really intends to promote it.' He was cynical about the good done by people who effected to trade for the public good. However, we live in an age of much greater transparency and openness. If we had an expectation that companies which operate in society and need a mandate from society to operate should operate in the public good as they make profits, then companies will do that. There is no need to specify how much public good is done or how they should do it. Boards can decide how they think they can best describe how the company generates public good. Readers of what they write can judge. Quality reporting about what is done should mean that companies which are effective in both making profit and doing public good will be rewarded. It is necessary of course that reporting must be true and fair and that glib, empty or misleading statements are dealt with. Companies must restrain themselves from using such reporting as a public relations exercise. Transgressions we hope will be spotted. Our social media age should ensure that any misleading reporting is quickly highlighted.

It may be better not to define the public good but leave it vague because more definition could invoke Goodhart's Law (referred to above) and encourage people to game it. The public good is of course not just about economic good. While economic well being is nice, other things are equally if not more important. Bhutan has the concept of Gross National Happiness and, theoretically at least, is governed so as to raise happiness. Unlike GDP, it is not one target but a basket of targets across nine areas so its susceptibility to Goodhart's Law should be limited.

While securitisation of loans can serve a valuable public good in enabling people with funds to provide them to people wanting them and for risk to be taken on by people best placed to take the risk, the system went off the rails. Financial institutions were able pass bundles of debt and related derivatives to people and other institutions with little idea of what they were buying. Those involved had every incentive to game the system and no incentive to do a public good. It is hard to envisage how the resulting bean feast could have been described by anyone as being in the public good; a for companies to report how they work in the public good may have made staff more socially aware and kerbed animal spirits when there was no other restraint.

The concept of public good gives a clear moral steer or compass but tremendous flexibility in how companies can contribute. This idea may sound radical but the UK company law framework already went some way towards this when it adopted the enlightened shareholder concept in the UK Companies Act 2006. The Act, in section 172, conferred a duty on directors to promote the success of the company and, in the course of making their decisions to that end, they are required by law to 'have regard' to:

1. The likely consequences of any decision in the long term.
2. The interests of the company's employees.
3. The need to foster the company's business relationships with suppliers, customers and others.
4. The impact of the company's operations on the community and the environment.
5. The desirability of the company maintaining a reputation for high standards of business conduct.
6. The need to act fairly as between members of the company.

It is implicit that, in having such regard, directors do not cause the company to harm the community or the environment. An amendment to include explicit reference to the public good would merely provide a subtle but vital direction in legislation to boards and companies.

The Role of Shareholders

At present this legislation can only be enforced by shareholders. Shareholders have never attempted to enforce this through the courts and it is not clear how, if at all, boards pay attention to it.

Given that a substantial proportion of the shares of large listed companies is owned by institutional shareholders investing on behalf of millions of people, it is reasonable to expect such companies to have regard for the public good. Most smaller businesses do this already. To a great extent, they rely on trust and common sense within the business to operate rather than on relying on detailed internal controls. They are generally formed and evolve to meet a market need and in so doing contribute to the public good through Adam Smith's invisible hand; they are not usually able to exploit the benefits of oligopoly or game regulation.

Institutional shareholders should be encouraged to take an active interest in how their investee companies work in the public good. This could be the missing part of an otherwise ineffectual Stewardship Code. The UK Corporate Governance Code, which presently makes only makes passing reference to ethics, and puts too much emphasis on compliance with provisions at the expense of upholding principles, could also include a main principle that companies work in the public good and require companies to report truly and fairly how they do so.

Doing the Right Thing and Ethical Self-Assessment

Considering the public good would also provide a directional steer for regulation and supervision and could enable considerable reduction in regulatory complexity. Supervisory action taken transparently by reference to the public good should be simpler to enforce. A financial institution or company would have a clear test and would know it might have to explain its actions. Surely this would be better than slavishly checking compliance with a regulation which may well in any case have

unintended and unfortunate consequences.

If we think once again of Volkswagen, we would think of VW as being a major contributor to the public good - the makers of the first people's car. The dramatic revelations about emissions testing do not really change this but they tarnish an otherwise fine reputation. It seems unlikely that top management initially approved the use of a device to cheat emissions. We can imagine a situation where lots of clever engineers are engaged in innovation and finding new ways to do things. These engineers may work in an environment where results are rewarded and there may be some pressure to perform. Finding a way to make emissions test results look better may have been more an intellectual and engineering challenge to solve rather than an attempt to deceive. Their supervisors may have been impressed with the engineering cleverness of the solution and not given a thought to the ethics of what they were doing, or at least not thought about the ethics until it was too late.

This is the problem with ethics in companies today and this is the systemic problem. People are too busy to think about ethics and consider whether their actions would be viewed as ethical by people outside the organisation. There is a simple solution and it complements the suggestion that companies report how they contribute to the public good. Companies should introduce a process of ethical self assessment. As part of this workshops would be held where staff consider hypothetical dilemmas and consider questions like 'is there anything going on here which would cause embarrassment if it became more widely known?'. Such a process would provide essential time for staff to reflect and consider whether there should be any ethical concerns. Such workshops need to be safe for people to take part, that is staff must feel free from fear of retribution. At VW asking this simple question in a way that allows people to answer without fear would almost certainly have resulted in some people answering yes. The facilitators could find out why they answered yes and serious problems could be communicated upwards. The fact of holding such meetings however should mean that unethical behaviours are unlikely to happen in the first place. Someone will question if it is the right thing to do before the action or soon enough to prevent damage.

Virtue has its rewards. Companies which explain their programme of ethical self assessment as part of the governance and risk management disclosures and companies which explain how they contribute to the public good will find favour with shareholders, customers, suppliers and staff.

Conclusion

There is an intrinsic satisfaction which most people derive from doing something good. The overall effect should be to promote trust in and outside the workplace which in turn would promote enterprise and lead to a healthier, probably more prosperous and happier society and reduce the regulatory burden. It may even help to restore faith in politics. ■

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