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Capitalism

I won't spend time defining capitalism, especially as its strength is its capacity to reinvent itself, and the absolute necessity that it will reinvent itself if it is to survive. The core of capitalism is the existence of a market for goods and services as well as a market for capital goods to produce those goods and services. The question: "Capitalism – quo vadis?" is a Eurocentric question posed in a dead European language. 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.

Dr. Rao said that capitalism is conceptually sound. Depending on the way you define the concepts and their theoretical inter-relationship that is, or can be made to be, so. However, most systems are conceptually sound. Communism as imagined by some of its idealistic proponents is conceptually sound: but it doesn't work. And some people have occasionally said the same thing about capitalism – not least Marxists in the past. The point of any system is to make it work and deal with its problems.

Quo Vadis – different answers

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 it has a vital but defined role within a larger ethical order. The third is essentially what Adam Smith said in the first place – something of which we should remind ourselves as we approach the 250th anniversary of his 'Theory of Moral Sentiments' which provided the ethical framework within which *The Wealth of Nations* was placed.

In the 1930s, statists of the right and anarchists of the left said that capitalism had nowhere to go. It was the American social democrats who actually saved capitalism from itself.

In the 1970s, the statists of the left said it 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 – something that, given Milton Friedman's eyes, was so perfectly realised by General Pinochet, wich was probably appropriate. He actually said that in democracy, if you have 49 percent of the vote, you get nothing. But in a market if you have 49 cents you get something. The point of course is that yes, the accounting principle is rather different, and anyone who has lots of dollars would probably prefer to have a democracy based on dollars rather than on votes.

The social democrats were the ones that saw capitalism playing a vital role in a larger order – with clear spaces for 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'.

In 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 – and a couple of the quite famous ones have decided to start moving backwards. It could well be they are third time lucky, but I suggest we seek counsel elsewhere, and look to the role of values to save capitalism from itself a second time, but also to let us all have a better understanding of the place of capitalism.

Many are familiar with Smith's famous line:

> "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."

For some time, I have thought that we might equally say:

> "It is not the malevolence of the mortgage broker that writes the NINJA loan, not the malevolence of the arms manufacturer that invents the cluster bomb or the polluter who destroys the planet – it is his self interest."

Self interest is an important driver but what we would now refer to as the ethical and regulatory environment that determines whether self interest is channelled to put bread on our plantation timber table or cluster bombs in our overheated and flood prone backyard.

Individual and Institutional Ethics

I want to talk very briefly about how capitalism can be made to serve our interests by trying to make it responsive to the real values of real people who actually these days own most of it, rather than a distorted version. To do so, I want to talk briefly about what I mean by ethics. I'll start with Peter Singer's basic question – ethical question – how should we live our lives? For me, the way you answer that question is to ask yourself hard questions about your values, give honest and public answers, and then try 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.

For the last twenty years, I have extended the question and the form of answer to institutions – leading to the important field of institutional ethics. This involves asking similar questions of the institutions in which we are involved whether they are government polities, faith organizations, courts, NGOs. As with individuals, it involves asking hard questions about the value of the institution, 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 question 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 etc. ?

Asking those questions involves an institutional and collective effort under its own formal and informal constitutional processes.

Similar to an individual, 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.'

This underlines what we have been emphasizing in our ethics work for nearly two decades. Ethics is not just about preaching values. It is about designing structures to ensure that your formal norms and your institutional structures actually make it likely that you will live up to your values. That's why Peter Eigen talked about a dichotomy between ethics, and institutions and rules. Where there is a dichotomy, it is a false one. Many people look at ethics and just see some charter and ask how the charter will translate into action. But if you just look at laws and institutions, you may rightly ask – what are they for? How do you know whether the institution is working? How do you know how to interpret the formal laws? In fact, ethics, laws and institutions can and must be mutually reinforcing, and will fail if not actually combined.

This process of asking what an institution is for and how it will achieve it requires institutional leadership, that is taking an institution through that process of creating an institution that lives up to its stated values.

Corporate ethics

If we apply this approach to corporations, we need to start with asking: what should the values of a corporation be? For a long time, people have said it is long-term shareholder value. I have often felt like quoting Hamlet's Horatio: "there are more things in heaven and earth than have dreamed of in your economic philosophy." Because really there are other things on this heaven and earth – but for the last 28 years, we have heard little of them. 'Shareholder value' has been 'crowding out' other values that shareholders, citizens and company directors hold dear.

I chair the Board which included a very committed clinical psychologist as Australia's corporate governance guru, Henry Bosch. There was a debate in which everyone was in furious agreement about conclusions but disagreement about how to reach them. Everybody agreed that we should make sure that the employees' health and safety was properly looked at, but there was a fierce debate about why we should do it. Henry Bosch kept on saying that the only thing we should look at is long-term shareholder value, but no sensible firm would ever cheat its customers, its suppliers, the community, the environment – it would be poor risk management. To this, the board critic said: "but that's not the only reason why you do the right thing."

Practical problems with shareholder value

Despite the popularity of "long term shareholder value" as an ultimate corporate goal, there are some fundamental problems with it. First, there are a set of practical reasons. It is easy to measure in the long-term, say in 20 years when the superannuant who invests in it finds out if the company is still in existence and is still profitable. But how do you plan to maximise long-term shareholder value? Henry says – you look after your customers, your suppliers and so forth. But how do you actually do that? How do you know what will maximize the value of the shares in 20 years? In fact, as the debate went on, it was very clear that Henry believed that if he did screw the environment or the consumers – then the company would be bound to fail. But he couldn't prove it – it was actually a matter of faith.

I will summarize the inadequacies of the "dollarized" (or 'dolorized'?) concept of shareholder value.

First, as Keynes said, in the long run we will all be dead.

Secondly, it is just not possible to determine what will actually maximise profit over the long-term. We cannot do the maths; it is just too complicated. What if a manager shows you a really profitable way to rip off some customers/workers/suppliers/community (possibly in another country) and argues that there is so much money to be made that, despite the backlash when we are found out, we will still be ahead in 20 years. Now how do you actually prove him wrong? More importantly, is it worthwhile going through and doing the maths?

Thirdly, the very willingness to contemplate the maths may be costly. Imagine a corporation that says that it will do whatever is required to maximize long term shareholder value within the law and that you believe avoid cheating customers/suppliers/community/workers because of the potential damage to long term shareholder value. Customers etc. may take the corollary seriously and be concerned that they might be the exception – the group that it is profitable to cheat. This will lead to more transaction costs as they ensure that they are not the exception.

Contrast this approach to that of what I call the "fanatical ethicist" – a corporation or an individual which says simply: "These are my values. That is what I'm going to do because that is who I am. I refuse to do the maths because it is a waste of time and even if the maths showed that I would be richer, the person who is richer would not be me." Imagine you have a choice of dealing with that person and the one who says: "I believe in long term shareholder value but I'll screw you if it's profitable", and someone who says, "with whom would you prefer to do business?"

This is the obverse of a warning we sometimes hear from some economists. We are sometimes told that trying to give money to the poor will not make them better off. It appears that if you try to look after your self too directly, you may end up doing the opposite. Certainly that has been the experience of a number of New York bankers.

Shareholder value – agency problems

The above are the practical problems. There is also an agency problem. What if you employ somebody to look after your long term interests, even if it occasionally means screwing the suppliers? Why won't he screw me as well?

Shareholder values

But what do the ultimate owners of corporations (shareholders and unit holders in superannuation funds) actually value? They certainly want profit and return over the long term. But real shareholders are not actually a cardboard cut-out economic man. The value of their superannuation investment in 20 years time is not the only thing they value. To suggest as much is an insult to the vast majority of people in developed countries and an increasing number of people in developing countries. Individuals who are only interested in their economic self interest would be sociopaths.

Indeed, if they were only interested in their economic interests as shareholders and unit holders, they would not only be sociopaths, but they would be incompetent sociopaths. The point is that they have other economic interests – the value of their house, their jobs, their children's jobs (nothing blunts a parents economic interests than having unemployed twenty-something offspring at home). Beyond that, they have economic interests as tax paying citizens and owners of other companies. If a company in which they are investing increases its profits by externalizing its costs, they are as likely as not externalizing it at the expense of those shareholders as citizens, investors, parents – let alone their other interests as drinkers of water and breathers of air.

The ultimate owners of corporations have similar values to citizens – not least because, in western countries, they are increasingly the same group through the extension of superannuation. The biggest problem with capitalism at the moment is that the decisions made by corporations do not respond to the real values of their ultimate owners. The fault does not necessarily lie in corporations. In every corporation, there are some who have really good long-term ideas about how to provide more effective and sustainable goods and services that will be wanted by consumers. There are also those who concentrate on short term profitability and their own bonuses. There will always be a bit of a struggle within the companies between those groups.

Capitalism's biggest current problem is that the outcomes of those struggles are not determined by 'shareholder values' – the values of the ultimate owners. Such owners are actively discouraged from thinking about the values that should inform their investments and all the intermediaries between them and the corporations they own. They are fixated on (and remunerated on) short term valuations through commissions and bonuses. The solution is for investors to get in touch with what their values are by asking themselves hard questions about what they think is important – and for intermediaries (advisors, super funds and fund managers) to facilitate the expression of those value choices.

Investors/Consumers/Citizens

Of course, individuals do not just act as investors. I have argued that people are responsible for the consequence of their actions, whether as investors, consumers or voters.

Campaigns, especially led by NGOs, should encourage people to act simultaneously in all three ways. Shareholder action takes time while consumer action can be very immediate. There is also an important role for citizens and government – though the more that corporations reflect the values of their ultimate owners, the less need there will be for regulation by the owners under a different guise (and with a different counting principle!).

Values and the Good Life

In suggesting that shareholders think about what they really do value, I am not suggesting that they do not reflect on their values. Indeed, I have been arguing for the last decade that the fundamental problem in global warming is that we have an unsustainable view of the good life that we have sold to ourselves and then sold it to the rest of the world. However, we are not going to save the planet by preaching to people that they should be good and give up things they value. What we need to do is to develop various ideals of the 'good life' that is not only sustainable but actually appreciated. Fortunately, the things that we actually enjoy more – good job, good company, family – do not need to break the ecological bank. In developing these views of the good life, we need insights from all directions of the compass – from east, west, south, north – which is why we probably need to put this question in a lot of different languages and not just Latin.

Concluding remarks

In posing the question: "Capitalism Quo Vadis?" in 2008, some may be saying "nowhere". None will be saying "everywhere." But most people in most countries do believe in both markets and democracy. They do believe in a role for Friedman's democracy of one dollar one vote in some spheres but one person one vote in others. What is needed is for the boundaries to be set by the relevant polities. I have long argued that it is not for the markets to determine the role of democracy; it is the role of democracy to determine the role of the market.

One such issue on which there may be change is in carbon markets. In this decade, most people have agreed that we need to send price signals to those engaging in unsustainable activity. Most have favoured carbon trading, rather than carbon tax. I have to say 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 seeing 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 guys who destroyed 5+ trillion dollars of value should be given the role of building the carbon market to save the planet? That is a rhetorical question in case nobody noticed! I have argued that carbon markets are a very bad idea for a number of reasons.

My alternate suggestion is that we tax carbon rather than consumption. This gives us the entire value of VAT to play with in sending price signals without creating inflation. In order to avoid global warming, we want ultimate investors to think about their values and drive it that way. But, we also want to send market signals and I think we should do it in that way rather than create yet another new market. Ultimately, that decision has to be made by the polity on the principle of one vote one value rather than one dollar one value.