

Capitalism and the concept of the 'public good'

What shocks you? After corruption scandals involving politician failed and failing pensions, eye-watering sums to bail out banks and slightly smaller but still eye-watering bonuses in the financial sector, our capacity for outrage has been dulled. There is a sense of resigned acceptance that there is little that people can do about it and that we and future generation of taxpayers will be worse off for years as a result. Such acceptance is tempered with a growing cynicism and lack of trust in politics, finance and business.

Following years of industrial in the 1970s, when business was branded by many as a villain, a widespread view 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 a society as a whole.

Finance services became the engine of growth. Economic prosperity increased for most people but the gap between rich and poor widened dramatically. Then came the crunch. We still do not know whether the financial crisis caused just a nasty but relatively short blip in economic growth or is still causing something worse. It does, however, seem already to have 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 has happened before, 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 that laws were broken. We know that following the rules does not necessarily equate with food ethics. In fact, we have seen many examples where practices that failed the test of public acceptability were met with the defense that 'we were following the rules'. Unfortunately, gaming-the-rules rather than playing-by-them

Capitalism cannot exist without society, and 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 see society as, in effect, capitalism's prey and this fits well with our 'want it now' culture. The image 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 husband livestock while looking after the environment. This approach builds trust builds trust and that is good for business and for society, and it necessitates a long-term approach.

RULES AND REGULATION

How could we bring this about? The response of governments, indeed almost anyone in a position of authority, is to think about making more rules. But having more rules is not the answer, the answer, the financial crisis having exposed their limitations. 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 might not have happened if the Basel framework had not created the 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. There is also an argument that financial reporting and auditing standards have become too rigidly based on rules. The accounting profession is again questioning purpose of accounting and auditing and asking whether it is sufficient to comply with relevant technical standards. The International Federation of Accountants is currently consulting on a public interest framework.

ACCA has long held the view that principles are more important than rules. Nonetheless, some people do not like principles on the ground that they create too much ambiguity, while a few 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. People like certainty about 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 if they fail to uphold principles.

Have we reached a point where there are just too many laws and rules? Should we try to return to situation where there is more emphasis on common law, where action are interpreted according to precedent, principles and commonsense rather than compliance?

MEASURING VALUE

Adam Smith divided incomes into profit, wage and rent. In profit-seeking behavior, entities create value in a competitive environment by engaging in mutually beneficial transaction. This is the invisible hand that 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 recipient's ability to benefit from special privileges conferred by favorable or ill-conceived regulation. Such privilege might include benefits from monopoly or oligopoly, quotas, licensing, regulation and state support. A rent-seeking behavior 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 applies to the probability of the banking sector. A shortcoming of our present reporting framework is that it does not distinguish between profits that are earned from value-creating behavior in a competitive environment and transfer of wealth through rent-seeking behavior. There is a role for the accountancy profession in developing new ways of measuring and reporting on value creation.

There are, however, problem with measurement. One such problem is that of achieving appropriate precision. Valuation of hard-to-value items, such as land during a recession or mortgage-backed securities during 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 phenomenon is sometimes known as Goodhart. It means that a measure turned into a target for policy will lose the information content that qualified it to play the role in the first place.

A crazy example is a Soviet-style factory, which, given the target of producing as many nails as possible, produces lots of tiny useless nails and, when given a target based on weight, produces 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 the health sector. The public sector is plagued with examples, such as a hospital that introduced a waiting list for going onto a waiting list, when healthcare-sector waiting lists became a target to be managed down. In banking, the Basel framework facilitated the shadow banking system and a dependency on credit rating. In one of the few management accounting novels, *The Goal*, E.M. Goldratt shows how seemingly sensible production targets could lead to bottlenecks and to bankruptcy.

New thinking is needed. It is now widely recognized that a change in culture is needed and many people are aware of how difficult this is to bring about by regulation. The UK coalition government talks of a 'Big Society', an aspiration that is 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 making a profit.

THE PUBLIC GOOD

The Golden Rule, found in most of the world's religions, 'do to others as you would have them do to you', does not give any particular direction or sheer. In general, most company and professional ethics frameworks and codes also do not give a clear direction: they lack a moral compass. Even those that are expressed in terms of values rather than conduct contain much ambiguity. It is too simple to say just 'do the right thing', but this is the essence of what we need.

A requirement to conduct enterprise for public good might do the trick. Everyone has a sense of what constitutes the public good. There may be occasions when one person's sense of public good may be another person's idea of public opinion, if the principle were 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. We, however, 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 do so, 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. Quality reporting about what is done or how they should do it. Quality reporting about what is done should mean that companies that are effective in both making profit and doing public goodwill be rewarded. It is necessary, of course, that reporting must be true and fair and that glib, empty or misleading statements are dealt with and companies must restrain themselves from using such reporting as a public relations exercise. Our internet age, however, means that any in appropriate reporting is likely to be spotted quickly.

It may be better not to defined the public good but leave it vague, because more definition could invoke Goodhart's Law and encourage people to 'game' it. The public good is not, of course, about economic good alone. 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, this is not one target but a basket of targets across nine areas so its susceptibility to Goodhart's Law should be limited.

Although securitization 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 wanting them, and for risk to be taken on by people best placed to do so, the system went off the rails. Financial institutions were able to pass bundles of Debt and related derivatives to individuals and other institutions that had every incentive to 'game' the system and no incentive to the public good. It is hard to envisage how the resulting bean feast could have been described by anyone as being a public good; a requirement to work in the public good may have 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 confers a duty on directors to promote the success of the company and, in the course of making their decisions to that end, are required by law to 'have regard, to a number of specific factors.

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

THE ROLE OF SHAREHOLDERS

At present this legislation can be enforced only by shareholders and such enforcement would be difficult to apply to the concept of protecting the public good. It is not clear how, if at all, boards pay attention to their responsibility to the 'enlightened shareholder'.

Given that a substantial proportion of the shares of our large listed companies are owned by institutional shareholders investing on behalf of millions of people, it is reasonable to expect such companies to operate in the public good. Most smaller businesses do this already. To a great extent, they do not rely on trust and common sense within the business rather than on detailed internal controls to operate. 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. Nonetheless, a possible exception to the latter could be the super profits from property development during a period of credit expansion. This occurs as a result of the planning system, which for understandable reasons restricts development.

The next step would be to encourage institutional shareholders to take an active interest in how their investee companies work in the public good. This could be the missing part of the FRC's Stewardship Code. The UK Corporate Governance Code, which currently makes no explicit reference to ethics, and which arguably 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

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 that may well, in any case, have unintended and unfortunate consequences?

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

