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Responsible Capitalism

Business for the 21st Century

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INTRODUCTION

The last ten years have seen clarion calls for the reform of capitalism, as evidenced by the essays in the present volume. However, most calls fall well short of what is needed, and represent only partial success. The main reason for a lack of thoroughgoing reform is the standard story of business and capitalism that is deeply embedded in our culture in the West and, indeed, has taken hold around the world. This main narrative about the nature of business and capitalism focuses on the pursuit of profits and "the physics of money" (Freeman et al., 2010) as the main characters in the story. Human actors are depicted as self-interested economic beings who are in constant competition with each other, either individually or within their business organizations. Most attempts at reform retain this standard narrative.

True reform of the idea of capitalism must address this underlying narrative and propose a different story, and that is our task here. In these few pages we can only briefly sketch the story, however, the good news is that this new narrative of business is being realized every day by a collection of companies that span the spectrum from start-ups to multinationals (see, for example, Sisodia et al., 2014; Mackey and Sisodia, 2014). Indeed, we shall argue that once we understand this new narrative we can become more aware of how its main tenets have always been present, if underemphasized, in great businesses and business leadership.

We proceed as follows. In the next section we sketch the tenets of the old narrative more precisely, and we highlight some of the partial suggestions for reform. Then we turn to a set of principles developed by a group of scholars over the last 40 years in what has come to be called "stakeholder theory," and suggest that these stakeholder principles are more useful in understanding how businesses need to operate in the 21st century. Finally we summarize with some principles of what we call "Responsible Capitalism."

SOME PARTIAL SOLUTIONS

The standard understanding of business by many is mainly from an economic point of view. In this view there are buyers and sellers, each looking to attain what the other offers at the lowest possible price. Economic theory is a set of propositions about the conditions under which this is possible and is one of the main vocabularies through which we understand business. The most common understanding goes something like this: business is about maximizing the returns—measured in profits, or stock price, or some such financial measure—to the owners of capital, i.e., shareholders, banks, bondholders, etc. By seeking to maximize the interests of these owners, society is better off, at least according to certain strands of the theory (Friedman, 1970; Jensen and Meckling, 1976). In addition, in order to maximize their investment, owners of capital must adequately control the activities of the business. In short, we can see business people on this view as solely concerned with profits and money. Further, since we are using the vocabulary of economics, the actors care only about their own interests—which in reality may well be other regarding, and maximizing those interests. The drive to compete and win is the ultimate energizing force of business, and the realization of that drive makes society better off.

There is much that is wrong with this characterization of business and capitalism, not the least of which that it is something of a "straw man" argument—easily blown over, as well as a characterization of actual practice. However, the picture does resonate with the popular conception that business is primarily about profits, money, and self-interest. We shall leave a more nuanced parsing of this view for another occasion or other scholars. Suffice it here to say that there have been calls for reform, especially given the global financial crisis (GFC) that has been laid directly on the doorstep of this view of capitalism.

For starters, some have argued, since Marx, that the primary deficiency of capitalism is that it pits "capital" against "labor" (Jameson, 1991). In such a battle, capital is bound to win, unless labor can organize, call strikes, etc. In modern terms, some theorists have called for more participation in the management of the business by its employees, not just its executives. Companies such as Toyota, who have empowered assembly line employees to be responsible for product and manufacturing quality, have indeed outperformed their more classical capitalist rivals such as General Motors. Many have argued that pitting capital versus labor is a false dichotomy (Follett, 2011). It is surely in the interests of owners, managers, and employees to cooperate together to create value. However, the old story of business says that this value is always claimed by the owners of capital at the expense of labor. This assumption prevents more thoroughgoing reform.

Second, some have argued that we need to take more account of the role of government. According to the standard narrative (Freeman et al., 2010), the appropriate role of government is to regulate the otherwise unbridled search for profits by businesses; without regulators, business would be allowed to create havoc for society. This role of government is often attributed to Keynes and his followers. Government action is as necessary as is the tending of a gardener to a garden, according to their metaphor (Keynes, 2006). Without government there would be chaos and disorder. Whether the modern-day monetarists such as Friedman agree or disagree with Keynes makes no difference. The idea of government as a necessary actor to ameliorate the fluctuations of the market and the behavior of business is the same.

Surely, the GFC taught us that business does not exist in a vacuum. Rather, we should see it as an institution that is embedded in other societal institutions, with government being one of these. There have been a number of calls for regulation, since the GFC, as well as real regulatory reform, such as Dodd-Frank in the United States, and a number of regulations on executive pay in other parts of the world. Again, the problem is that the basic assumptions about business remain the same. Dodd-Frank assumes that businesses and banks remain best described as driven by profit, and that there should be side constraints imposed on this "natural" drive. Reform is again piecemeal and partial.

Finally, there are a number of reforms that are aimed at improving "corporate governance" by paying more attention variously to the interests of shareholders, executives, and employees in the basic structures of boards of directors and the day-to-day management of the business. All of these reforms are well meaning yet they stop short of questioning the basic assumptions of business (Bebchuk, 2006). It is to those basic assumptions that we now turn.

STAKEHOLDER THEORY AND THE BASICS OF BUSINESS

What makes any business successful and sustainable over time? The answer from a practical point of view is that it continuously creates value for its customers, suppliers, employees, communities (and civil society), and its financiers. If it loses the support of any one of these groups, then it is vulnerable to failure. If it ignores any one of these groups over time in a free society, that group uses the political process to enforce its claims. Business is a voluntary activity, for the most part. And, those who engage with a business do so voluntarily, since they usually have some amount of choice about whether to do so. Of course, the existence of choice depends on the underlying structure of society, but as in the case of neoclassical economics, we want to assume that some form of property rights or some other basic moral regime can be appealed to in order to give business some legitimacy—issues that are complex and beyond the scope of this chapter.

So, any business must create some value for its customers with products and services that make their lives better off, so that customers are willing to pay for them. Any business must work with suppliers, as their customers, for the same reasons. Businesses must create value for employees so that they are willing to learn how to operate various aspects of the business. And, research is clear that the more employees are engaged in the business, the more successful the business (Edmans et al., 2014). It is a bit more controversial that business must create value for communities, but nonetheless it is true. Communities have often spoken out via the regulatory process or the courts and prevented a particular business from operating within its boundaries. More often communities have sought restitution when a business has damaged a community. And, of course, any business must have the support of its financiers, a point acknowledged by the old narrative.

However, we need to go further. The interests of each of these stakeholders do not exist in isolation. How engaged our employees are surely affects our ability to innovate and produce quality products for our customers, and there are similarities among all stakeholders. There is now a burgeoning and substantial literature on how stakeholder interests affect all areas of business (see Freeman et al., 2010; and Parmar et al., 2010 for the arguments and references). Indeed, all real businesses continually try and satisfy stakeholders. The introduction of this simple and practical idea of "creating value for stakeholders" turns the old narrative on its head (see also Chapter 12, this volume). In fact, we can suggest a number of different assumptions that form this new narrative of business, which are summarized in Table 10.1. Please note that we are not trying to be complete and mutually exclusive here, but merely aim to illustrate the kind of ideas that are necessary to really reform our old idea of business and capitalism.

Let us discuss each of these in turn:

The Unit of Analysis Assumption

A useful unit of analysis of business is the set of stakeholder relationships rather than discrete economic transactions. Most businesses consist of the voluntary cooperation of at least customers, suppliers, employees, communities (including civil society), and financiers. This cooperation includes the ability to make agreements that extend over time periods based on fairness and trust, rather than merely transaction by transaction. Value gets created for each stakeholder because each can freely agree to cooperate with the others.

Table 10.1. Changing the assumptions of the business narrative

New assumption		Replaces old assumption	Implications
The unit of analysis assumption	Businesses consist of the voluntary cooperation of at least customers, suppliers, employees, communities (including civil society), and financiers.	Business is conducted transaction by transaction.	If capitalism is to flourish it will be because individuals and groups of individuals can work together to create value for each other. Collaboration only works when there is freedom of association and choice.
The interdependence of stakeholders assumption	There is a jointness to stakeholder interests. Each stakeholder contributes to the value that is created for the others.	Executives have to make tradeoffs where the value created for one shareholder reduces the value created for stakeholders.	Business is fundamentally a cooperative enterprise built to create value, trade, and make ourselves, and others, better off.
The complexity of human motivation assumption	We are pro-social, language-using collaborators. And, most of the time we aspire to be a part of something that is larger than our own individual self-interest.	We are primarily self-interested and opportunistic.	Most of us, most of the time, want to and actually do take responsibility for the effects of our actions on others.

Most people keep most of their agreements most of the time (see below for its underlying moral framework). By looking at a large group of stakeholder relationships, rather than a single transaction, scholars and practitioners can better understand the effects of managerial decisions on a broader system of relationships. This is important because it allows us to create ways to make decisions that benefit the ecosystem of stakeholder relationships, rather than trying to maximize a particular variable within a transaction and then causing value-destroying consequences in other areas.

The Interdependence of Stakeholders Assumption

There is a "jointness" to stakeholder interests. For instance, employee well-being is connected to customer well-being, etc. Each stakeholder contributes to the value that is created for the others. Value is created within the context of others. And, rarely is this process reducible to mere contracts. The task of the executive is to continuously work to get stakeholder interests going in the same direction. This works best when executives see the interdependence among stakeholders. It works least well when executives have to make tradeoffs where the value created for one stakeholder reduces the value created for others. This interdependence requires a set of skills and ideas that use executive imagination. And, this is best exercised in full engagement with the stakeholders themselves. Stakeholder engagement is sometimes thought to entail corporate social responsibility. Nothing could be further from our idea here. Stakeholder engagement is about how a particular firm's business model creates value.

The Complexity of Human Motivation Assumption

Capitalism works because human beings are complex creatures. We are at once self-interested and other regarding. We are capable of both selfish and selfless acts. We are pro-social, language-using collaborators. And, most of the time, we aspire to be a part of something that is larger than our own individual self-interest. Most of us, most of the time, want to and actually do take responsibility for the effects of our actions on others. The complexity of human behavior is writ large in our culture, our art, music, and literature. As we learn more about human behavior from its scientific and literary study we find less application of the simplifying motivational structures of traditional economic theory.

The three basic assumptions together with the implicit moral framework here form a different basis for understanding business. The implicit moral framework is not some idealistic fantasy, but one based in both science and cultural theory. Human history is partially a history of us cooperating together to achieve lifting billions out of poverty, and making a better life for ourselves, our families, and our communities. Such a project founders if the participants have no need to be responsible to those whom they affect with their actions. Indeed, the stakeholder idea is simply based on the idea that we need to be responsible for the effects of our actions on others. Such a basic principle is a part of every ethical system, religious belief, and guide to human interaction that has ever been invented or discovered. Of course, there are some who take advantage, but the idea that the main way we create value for each other depends on our willingness to "get away with whatever we can" is an idea that has long outlived any usefulness it may have had. Such an idea of "cowboy capitalism" should be put aside and made optional at best.

Any reasonable reform of capitalism and business must be put on a firm ethical foundation so that "business ethics" ceases to be a joke or an oxymoron. We argue that we do not need a very high edifice here, but rather a garden-variety common-sense view, that we teach all of our children simply to be responsible for the effects of our actions on others. Note that this assumption of responsibility applies to stakeholders in a business as well as to employees and executives. In the current parlance, many assume that it is only companies who need to be responsible (Goodstein and Wicks, 2007), but this assumption is as faulty as its opposite.

RESPONSIBLE CAPITALISM

The previous section suggests that we have come to see business differently. Business is fundamentally a cooperative enterprise built to create value, trade, and make ourselves and others better off. Since it is fully embedded in societal institutions we can also sketch the moral ideals on which it is based. So let us briefly sketch a set of criteria for proposals of reform of capitalism and business from our earlier discussion:

Responsibility Criterion

Any reform of capitalism must address the question of who is responsible for the effects of business activity on particular stakeholders and on society. We believe that the answer to this question is best given as "a business and its stakeholders," but we recognize that there may be alternatives. Also, "responsibility" is a devilishly tricky philosophical notion. Often responsibility is a joint endeavor, and it can be opaque due to difficult causal mechanisms, or ignorance of those mechanisms. These difficulties just add urgency to the requirement to understand responsibility in more nuanced ways, and to use all of the disciplines at our disposal to do so.

Voluntary Collaboration

If capitalism is to flourish it will be because individuals and groups of individuals can work together to create value for each other. Collaboration only works when there is freedom of association and choice. Forced labor, or forced cooperation, or forced consumption, or forced investment, carry negative consequences. However, it is not often so clear what is voluntary and what is not. The very low percentage of people who are actively engaged in their work is in part a function of very low perceived freedom to act and to do what is best for their organizations. In the thriving businesses of the 21st century, employees must have the ability to work with others to create value, and they must have the time and resources to push value creation in new and innovative directions.

Competition as Emergent Property

Businesses, and business schools, are often obsessed with the idea that business is fundamentally a competitive activity. We believe that such an assumption simply misses the main engine of capitalism. Capitalism works because we cooperate together to create value that can then be traded to make everyone better off. Competition is important in that a free society encourages voluntary agreement. And, if we can figure out a better way to do something, then we can satisfy a network of stakeholders better than they are currently being satisfied. Venkataraman (2002) has suggested that the entrepreneurial process leads to such equilibration as the result of a competitive economy. However, it may well be just a mistake to attribute the system-wide property of competitiveness to individual actors in the system.

Continuous Creation

Schumpeter (2013) famously wrote about the idea of creative destruction. Every company would eventually be replaced and destroyed by those who came after. However, this idea simply ignores the genius of the corporate form. Companies may well have a kind of limited immortality. In the 21st century companies don't stand still. They look for the next disruptive innovation, and some even look to disrupt themselves. Very large companies don't immediately go out of business when a better mousetrap gets to the market. They adapt. The adaptiveness of the corporate form is its innovativeness. It has good and bad qualities, but it lends some stability to a fast-changing world.

Government as Facilitator of Value-Creation Criterion

In calls for reform of capitalism, there are many proposals for the further regulation of business, usually from the left, and suggestions for "smart regulation," often from the right. Surely government has a role to play as referee, especially given the scope of the old narrative of capitalism. However, it stands to reason that if the main engine of business is collaboration to create value for stakeholders, one obvious question would be how government and other civil society organizations can facilitate the creation of value by businesses. We see a great deal of progress in this area as more companies are collaborating with non-government organizations (NGOs) on issues that range from industry working conditions to specific geographical and ecological issues. Companies such as Whole Foods Market routinely collaborate with animal welfare organizations to develop more awareness about conditions under which food is produced. McDonald's collaborates with environmental organizations on some issues of ecological significance. And, we have begun to see the emergence of public-private partnerships, usually involving private companies, NGOs, and governments cooperating together to solve problems that no single one of these organizations could easily solve.

We believe that in addition to its traditional role of referee and redistributor of value, government can play an important role as facilitator of value creation. There are a number of roles here, such as (1) coordinating, communicating, and validating information; (2) smart policies that encourage voluntary agreements to create value; (3) assisting education around business and entrepreneurship; (4) providing infrastructure to make business start-up and growth easier; (5) facilitating business growth and trade at an international level. Practical policies include the support of business incubators, changes in tax laws and regulatory regimes, the establishment of free and fair trade, encouraging companies to think broadly about stakeholder value, and making examples and role models out of the companies that do it right.

SUMMARY

We believe that we are at an inflection point in the history of capitalism. It is time to think broadly and creatively about the very best in capitalism, and how to avoid its historical weaknesses. In this chapter we have outlined that many of the weaknesses of capitalism come from inaccurate and unhelpful assumptions about the nature of business including its purpose and level of interdependence, as well as assumptions about the complexity of human beings. Without addressing these fundamental assumptions, calls for reforming capitalism—whether from business leaders or policymakers—will have limited impact. We have suggested that the scholars and executives, who have been working on stakeholder theory and its practice have given us ways to talk differently about these assumptions that unleash our potential to work together, increase responsibility, and make each other better off. These narratives must become more widespread and engrained in practice. Much work remains to be done in both developing theory and practice to continue this progress.

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