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COLIN MAYER - CAPITALISM AND CRISES: HOW TO FIX THEM

Thursday 13 June 2024

LECTURE TRANSCRIPT

Well, Adam, thank you very much indeed for that very kind introduction. And thank you for the invitation to speak tonight. It's a really great privilege and honour to do so and to follow in the footsteps of so many very eminent thinkers before me. So, thank you very much indeed.

And I'd just like to take the opportunity to pay tribute to one other person who is in this room tonight. It was almost exactly 50 years ago that I stepped into his room and sat in a chair in his giant room at St. John's College in Oxford. And I sat down and I waited for him to say something. And I waited, and I waited. And I said nothing, and he said nothing. And then what seemed to be after a decade, he said, well, I suppose I ought to arrange a supervision with you. It was a proposition I couldn't actually refute. And so started what was undoubtedly, was unquestionably the most important intellectual influence on my academic career.

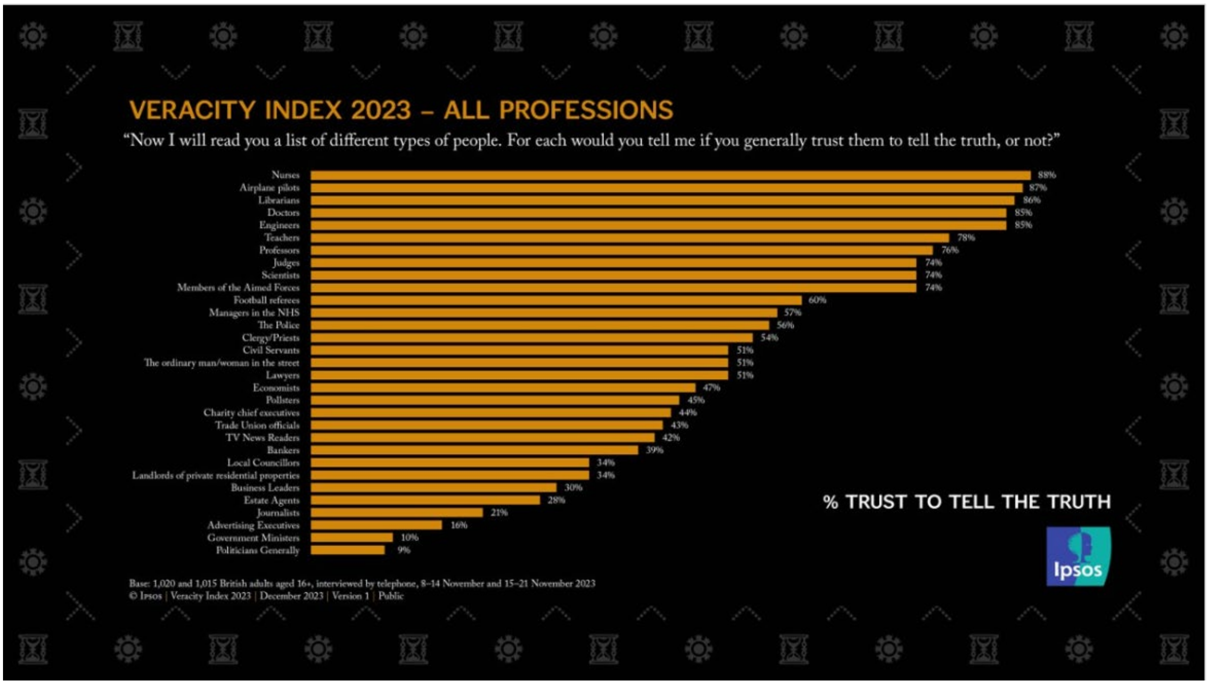
What marked out what was then Mr. John Kay and is now Professor Sir John Kay is the principle that he instilled, a principle that one can sum up as being that one should never presume that what appears to be is or must be. In other words, that one should always question what one might take for granted. And one should never presume that it's immutable, that it cannot be changed. And I think that that is actually probably the most useful lesson that any student and indeed any individual can learn. It's very different from what most great thinkers actually teach, they teach that what their ideas are and their knowledge is the truth, the whole truth and all the truth.

It is, of course, precisely what the great Scottish thinkers and the Enlightenment did. And people like Adam Smith and David Hume very much was of the spirit of questioning everything that was presumed and taken for granted. And were quite willing to throw out what seemed like immutable ideas.

And so I think that place is John in the category of being one of the great thinkers of the 21st century. So really, what I'm going to be saying this evening is, if you like, my final supervision essay delivered 49 years later. I think that John might find it agreeable, at least in part.

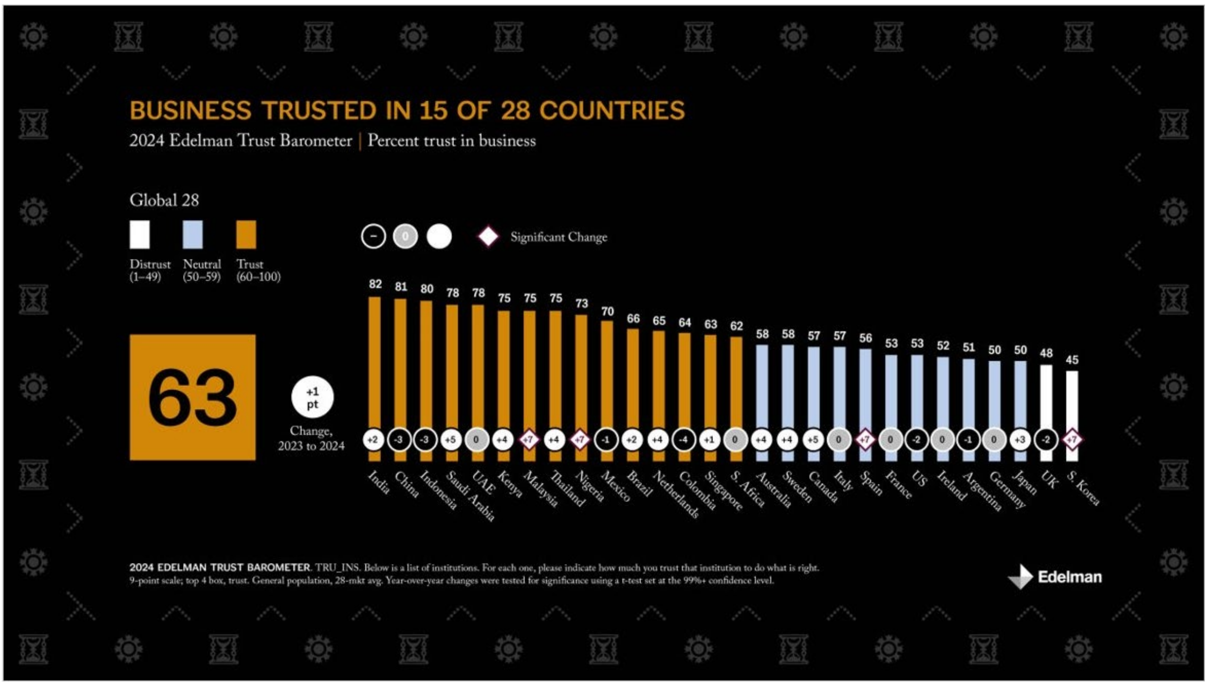
Exactly.

Capitalism is the most powerful engine that we've ever invented. And business is the most important component of it. It clothes, feeds and houses us, it employs us and it invests our savings. It's the source of economic prosperity, the alleviation of poverty and the growth of nations around. But at the same time, it's been recognised as a cause of growing environmental degradation, biodiversity loss, inequality, social exclusion, and mistrust.

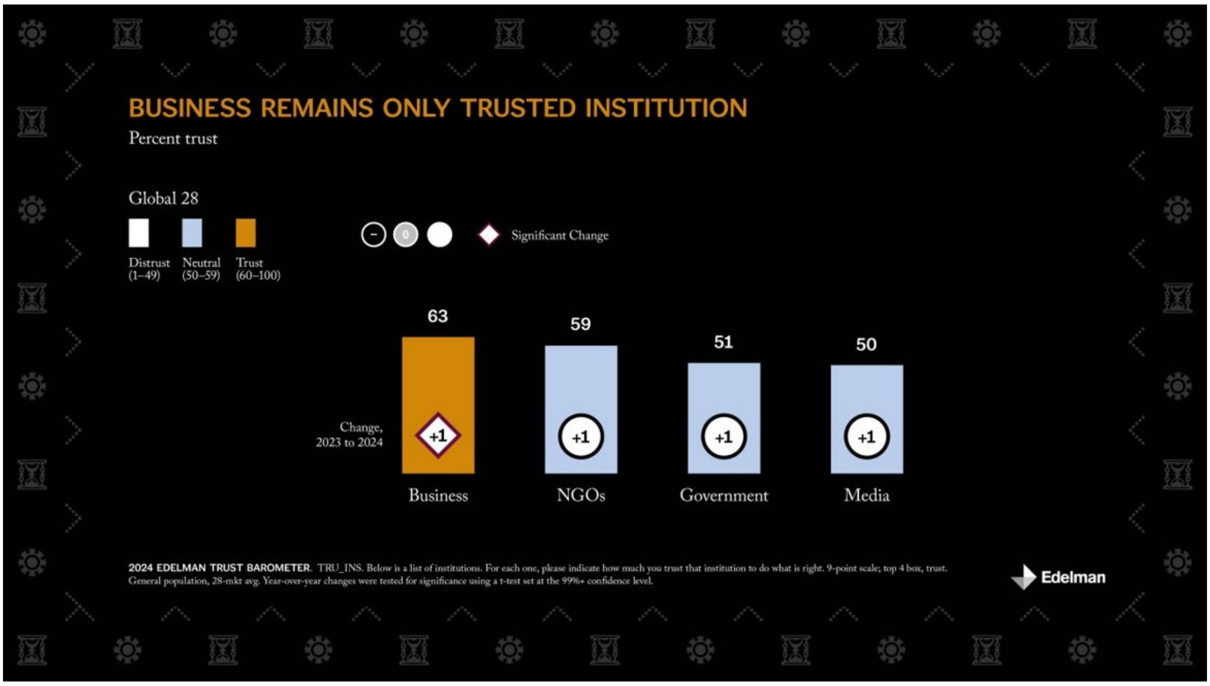


Every year for the past 40 years, Ipsum Mori, the market research company, has undertaken a survey of a thousand people in Britain as to which professions they trust to tell the truth. And as this slide here shows, alongside doctors, teachers and nurses, I'm pleased to say at the top are university professors. We might not have much power, pay, or prestige, but at least people trust us to do nothing, earn nothing and take no credit for it.

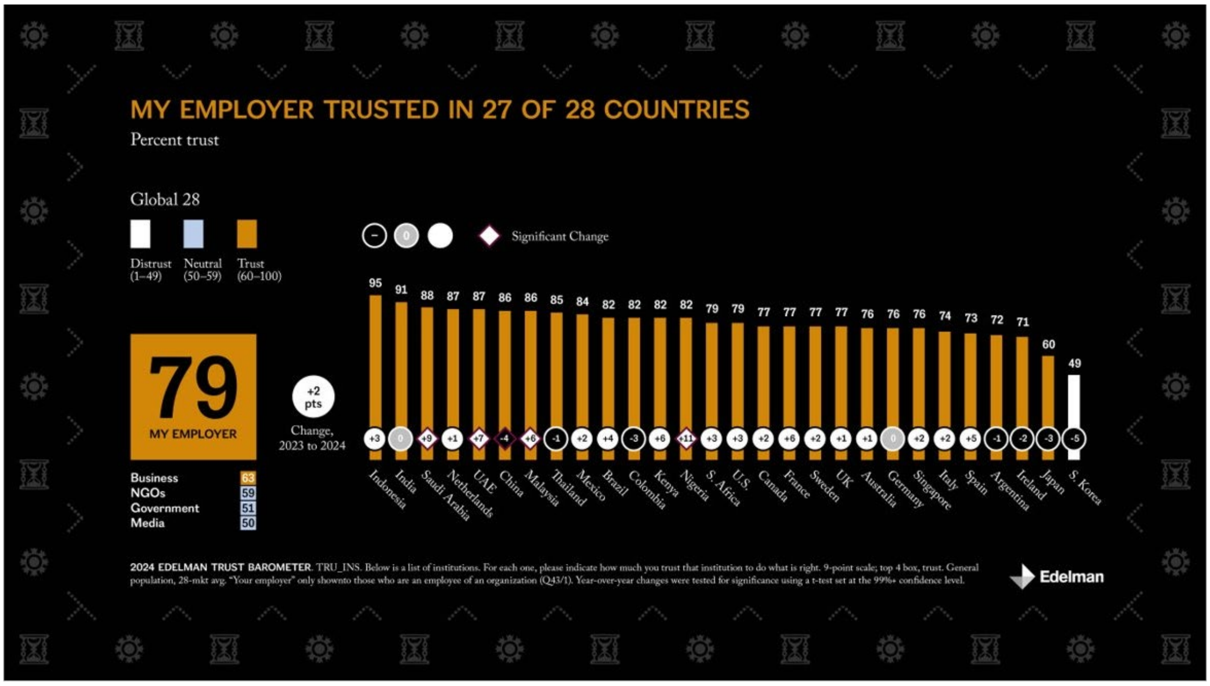
But as you can see at the other end, come business leaders, just ahead of estate agents, journalists, advertising executives, and rock bottom, yes, you've guessed it, are politicians. They come below bankers, trade union officials, and what is termed the ordinary man and woman in the street. And it's been true of virtually every year of the 40 years of the survey that business leaders are near the bottom. Mistrust in business is profound, pervasive and persistent. And indeed, the Edelman Trust Barometer produces now a survey of trust in institutions around the world.



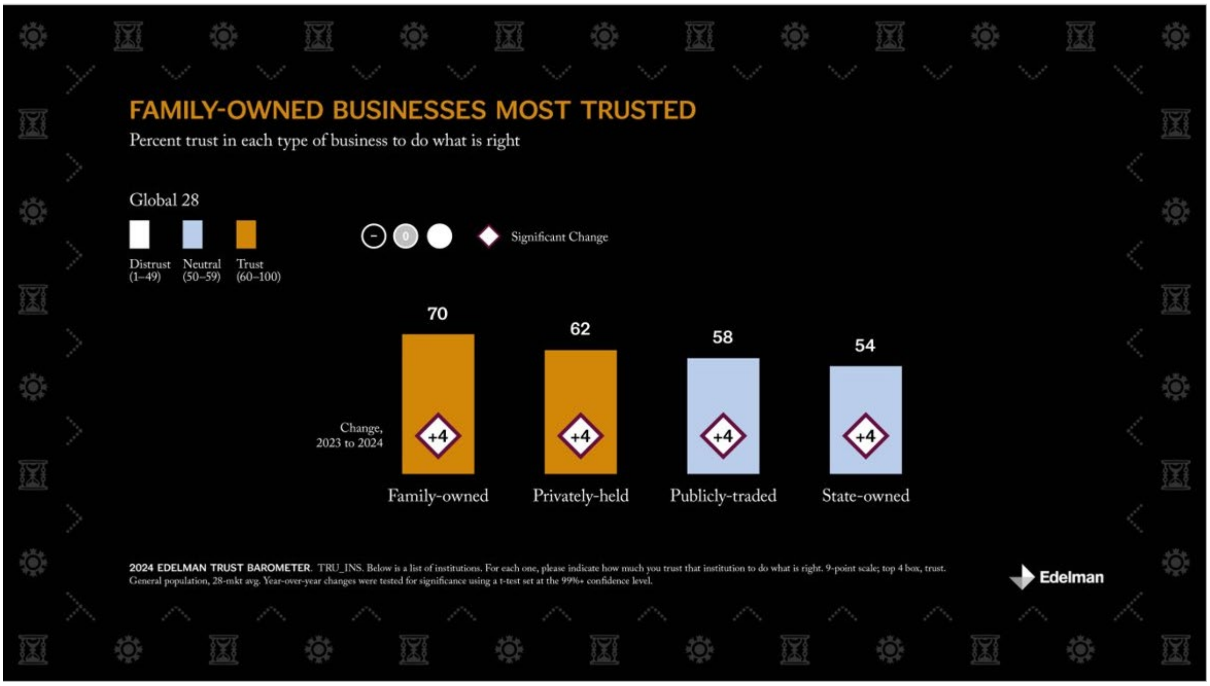
And we can see from this slide that trust in business in the UK is second from bottom of the 28 countries in the survey. This great nation that invented the Industrial Revolution and was the workshop of the world is now the second from bottom of trusted businesses in the world. And you might notice a striking feature that it's not only in relation to our other European competitors that we have less trust in business, but it's true of the developing and emerging world as well.



And indeed, if you look around the world, according to the Edelman Trust barometer, business is actually a relatively well -regarded institution, at least in relation to NGOs, government and media, which might not, as the first slide suggested, tell you a great deal. But it's certainly the case that in relation to the world position, Britain fares poorly.



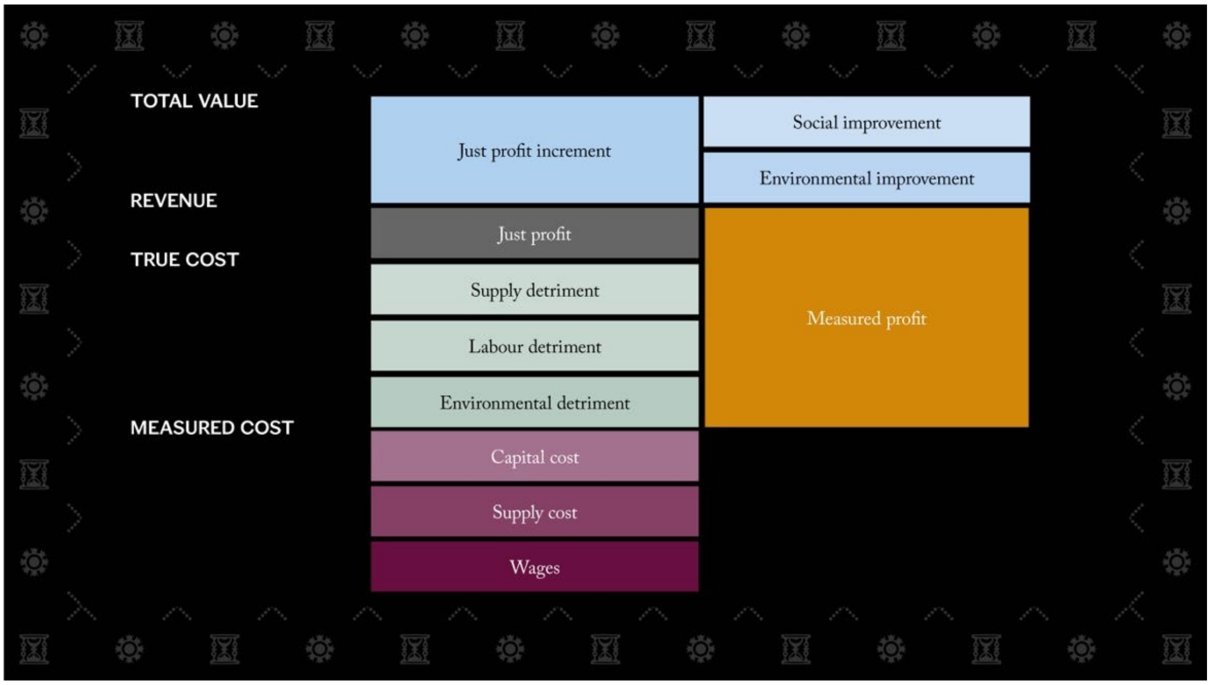
There's a tendency for people to have a greater degree of trust in their own employers than they have in business in general. Approximately 80% of people surveyed trusted their employer around the world.



And there's an important difference in terms of the nature of business. That family-owned businesses tend to be more trusted than those of other types of privately owned businesses, than of publicly traded businesses and of state-owned businesses. And while it's therefore often difficult to ascribe precisely what one means by ownership, there does seem to be a significance in terms of the relevance of ownership to trust.

So, why is it the case that there is at least a very ambivalent view, and in many cases in particular in the UK, a serious lack of trust in business? And I'd suggest to you, that the reason for this is the fuel that drives capitalism and business.

The fuel is of course profit. Profit is both the source of the resources of businesses and it's also the incentives that drives them. Without profit, there's no capital in capitalism. But we're misconceiving the nature of what a profit is. Profit derives from the Latin proficere, perfectus, to advance and progress. And that's really precisely what a profit should be. It should come from advancement and progress. And it often does, but too often it doesn't. And it comes instead from disadvantage and regress.



Now to understand why this is the case, we need to lift up the bonnet of capitalism and look at the engine that exists below it. And this is what you see when you do that. So, a measured profit is of course the difference between, yes, I realise I was warned about the fact that there's a danger of falling down, okay. That is the difference between the revenue or income of a company and its costs in terms of its employee costs, supply costs, its capital costs, and the difference between the two is the measured profit.

But of course, that isn't actually the profit of the business. Because what it doesn't take account of is the detriment that a business causes to other parties in terms of paying employees below a living wage, paying people in the supply chain below a fair-trade price, polluting the environment, causing biodiversity loss, emitting global warming gases, et cetera. And in particular, it doesn't account for the costs of avoiding those detriments and where they do arise, cleaning up the mess that the company is creating. In other words, it doesn't account for the true costs of a business.

And if you do account for the true cost, then as you can see from this, the actual, what one might term a fair profit or a just profit is and can be considerably less than that of the measure. And indeed, when the directors of a company sign off their accounts as being a true and fair representation of their financial condition, they're doing no such thing. It's neither true because it doesn't represent the true cost of the business, and it isn't fair because it's not then reporting a fair or just profit. But it's not just a problem of an overstatement of profit, there's also a problem of an understatement because companies can't necessarily earn revenues on all the good things that they do in terms of investing in their employees, supporting their communities, improving the environment, etc. They cannot necessarily capitalise the benefits that they are conferring.

But there's a difference, a marked difference between the two. A company can incur the costs of avoiding the detriments and cleaning up the mess. It can't just dream up the revenue stream associated with all the benefits it confers. It has to find innovative ways of being able to capitalise them. Now, obviously, the way in which as economists we think about this is, well, these are externalities. These are external to business. They're associated with the markets and market failure, associated with competition failures, regulation failures, taxation, reputation, litigation failures, all those sorts of things. But what I'm suggesting here is that it's not actually external to the firm. It's very internal, intrinsic to the firm, and in particular to this fuel that drives the business, namely profit. And because we're misdiagnosed, misdiagnosing the nature of the problem, we're prescribing the wrong policy solutions.

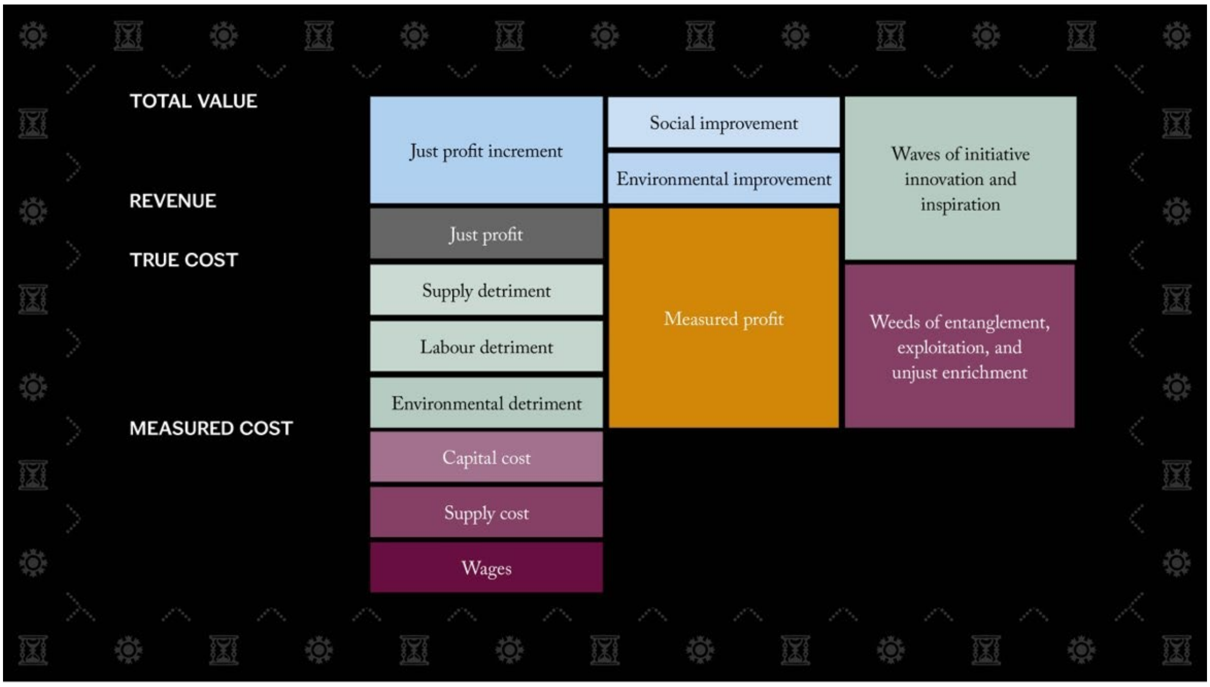
So, competition fails because good companies that incur the true costs and earn a just profit on their business cannot compete against those that don't and are in essence earning an excess profit. And as a consequence, capital flows from good firms to the bad firms that are earning a higher rate of return on their capital. So, far from solving the problem, competition or intensified competition can actually make it worse.

There's a sort of Gresham law of bad firms driving out the good. And regulation fails because companies lobby against regulation, they employ consultants to help them circumvent regulation and turn it to their competitive advantage. And as for reputation, of course we're outraged when we realise that companies are not earning profits from creating benefits but inflicting detriments on us, as we were during the financial crisis, which really came as a true shock to many people.

And as we're outraged from what the water companies are doing, in terms of earning large profits and paying their executives handsomely from dumping raw sewage into our rivers, lakes and seashores.

Now while there's consensus around the outrage, there isn't consensus about what to do about it. Because on the one hand, we have the socialist left and the environmental activists saying we need more regulation, tougher enforcement, more taxation. And on the right, the libertarian right, and the anti-woke brigade, we have them saying, no, no, no, that's an infringement of liberty and freedom. It undermines investment, growth, and employment. So, far from there being a consensus, there are strong divisions about what to do in regard to these problems. It's a source of polarisation of our societies and it's giving rise to burdens that the democratic system increasingly cannot deal with or tolerate.

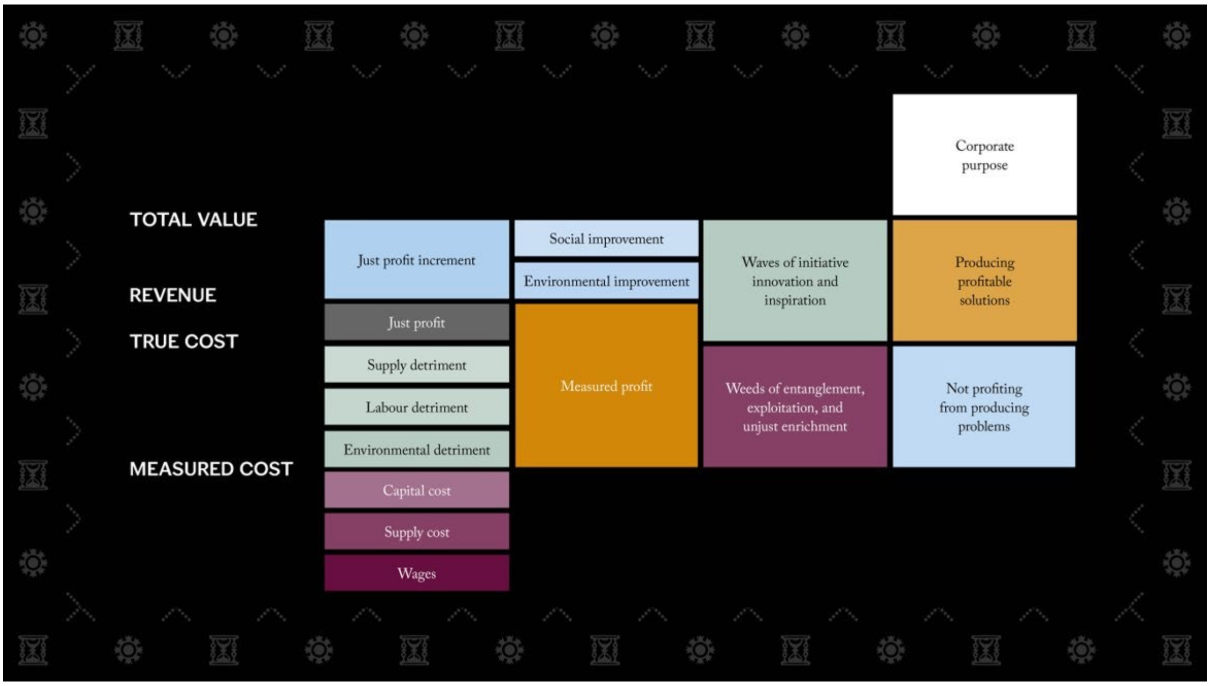
So, it's undermining both our societies and our politics. And what we need to do is to recognise so that as long as we just treat this as being an externality, then we're not going to solve the problem instead of recognising it as being inherent and intrinsic to the nature of business.



What we need to do is to elevate our sites so that instead of wading, as I put it here, in the weeds of entanglement, exploitation and expropriation of unjust enrichment, that we shift our views and elevate our aspirations for business to surfing the waves of initiative, innovation and inspiration that comes from incurring true costs and finding ways of capitalising on those profit increments that they should be able to earn.

And if you do that, two interesting things happen. The first one is that competition does really create a run to the top, not to the bottom. Because good firms that are earning a just profit are not now out competed by bad firms that are earning excess profits, but by better firms that have found ways of capitalising on the just profit, so we get a run to the top instead of the bottom. But more significantly, what it also does is then to bring an alignment of interest between business that is seeking to profit from creating benefits for us as individual societies in the natural world and the public sector, which is an interest in the public interest or the social.

At the moment, there is conflict. There's conflict that we see in terms of the failures of things like public -private partnerships and private finance initiatives that comes from the fact that too often the interests of companies are not aligned with those of the public sector. But by doing this, one creates a natural common purpose in terms of shared prosperity and by doing that, what one is doing is to encourage the public sector to assist the private sector with finding ways of capitalising some of those profit increments. And it's not just in alignment with the public sector, it's also in alignment with the not-for-profit and charitable sectors that have similar interests in terms of social and environmental wellbeing.



So, what we need to do is to think about how is it that we can actually bring about these desired changes. And at the heart of it is of course the notion of why business exists, why we create businesses, their reason for being, namely their purpose. And what this is suggesting is that in thinking about why we create business, obviously profit lies at the heart of it, as Milton Friedman famously said in his doctrine. But what it brings out is that the notion of a profit has to be thought of not as the purpose of a business, but as being derivative of a purpose of a business, of finding ways of solving problems and not creating for others. In other words, what a purpose of a business is in this context is to produce profitable solutions for the problems of people and planet. But there's a second part to it because what we also want to do is to ensure that companies do not profit from excess profits that are earned from creating detriments. In other words, they should not profit from producing problems for people or planets.

So, a purpose of a business should be to produce profitable solutions for people and planet not profiting from producing problems for either. And there's an important corollary that comes from that, and that is that if that is what the purpose of a business is, then a profit derives from producing solutions, not problems, for the rest of us as individuals, societies, and the natural world.

Now, in terms of actually achieving this, the critical element is to recognise that this notion of a purpose is not about marketing or promoting a company. It's not, as it's been essentially viewed over the last few years by many companies, a promotional device for looking good. It's about the core of what a business does. What Larry Fink described in one of his statements on corporate purpose as being what a business does on a daily basis. It should, in other words, be the fundamental driver of a strategy of a business. And in that regard, it's not vague or woolly. It's precise about what problems a business is there to solve, for whom, how it's going to solve those problems, where it's solving the problems, and why it's particularly well suited to solving those problems. And it's certainly not about corporate social responsibility, doing a bit of philanthropy on the side. And it's not even about environmental, social, and governance factors, ESG, as I'll describe in a little bit. This is about how companies determine their long-term strategic objectives that then get translated into their three or five year, whatever it is, strategies.

I want to illustrate this in relation to a particular example. And the example I'm going to take is of the Danish pharmaceutical company, Novo Nordisk. Novo Nordisk makes insulin, which is used in the treatment of diabetes, particularly in relation to what I'm going to talk about, type 2 diabetes. Novo Nordisk used to have as its purpose, its stated purpose, simply to produce insulin and to sell it at a profit. And then it realised that there was a problem with that stated purpose in the business. Namely, that 80% of type 2 diabetes is found in low- and middle-income countries, many of which could not afford to purchase its insulin.

So, it started to think again about what its purpose is. And it concluded that actually its purpose was to help people treat type 2 diabetes. So, it started working with universities, doctors, and hospitals around the world to identify different ways of treating type 2 diabetes, which might involve taking insulin, but frequently did not. And then it realised that actually its purpose was even more than that, more than helping people treat type 2 diabetes, helping them to avoid getting type 2 diabetes at all. So, it started working with governments, local health authorities, and local governments to identify changes in lifestyles and nutrition that would help people avoid getting type 2 diabetes at all.

Now you might say, well that's all very well and all very noble, but doesn't it undermine Novo Nordisk's basic business model of making a profit out of selling insulin? And the answer is no, its business actually boomed on the back of it. And it boomed because of the fact that in the process of creating these relations with doctors and hospitals, et cetera. It created relations of trust by which it became a trusted supplier of advice and products, and its business boomed on the back of that.

Now I think there are three important lessons to be learned from this. The first is the importance of bringing clarity to what a purpose of a company is. The second is no company can really solve a major problem such as diabetes on its own, it has to work with other companies and with other organisations in terms of solving those problems. And the third thing is, if you can bring real clarity to the nature of a company's purpose as a meaningful challenge in problem solving, and you can commit to that, as Novo Nordisk did, then you create the most valuable asset that a company can have, and that is to be trusted, to be trustworthy.

Now I want to illustrate how in practice companies can actually implement these types of approaches. In Oxford we've been working with a large group of boards of some of the largest European and North American companies in terms of how they can really effectively implement a meaningful challenging purpose in their business.

And we've developed a framework for doing that which we've given the name score to, where the five letters of score stand for an acronym for the main components.

The first letter, S, is for simplify, to simplify the company's purpose, to bring real clarity to it, just as I described Novo Nordisk discovering what its true purpose is. The second letter, C, is then to connect that purpose with the company's strategy, so it's the overarching framework within which the strategy sits. But it's also about connect in the sense of what Novo Nordisk did in terms of connecting its business to other organisations to help it solve diabetes around the world.

The third letter O is for ownership. Ownership in terms of the formal ownership of the company, but more significantly, ownership in the sense of everyone in the organisation having a sense of ownership of the company's purpose and recognising what their role is in helping to contribute to the company's purpose. And to do that, one has to have in particular an alignment of the culture and the values of the business with its purpose.

The fourth letter R is for reward, which emphasises that this is not just about culture and values, but it's about the hard-nosed monetary elements as well, in terms of the financial incentives, the remuneration, the promotion of people in the business, which means that the business has to measure its success and its performance in terms of delivering on its company purpose.

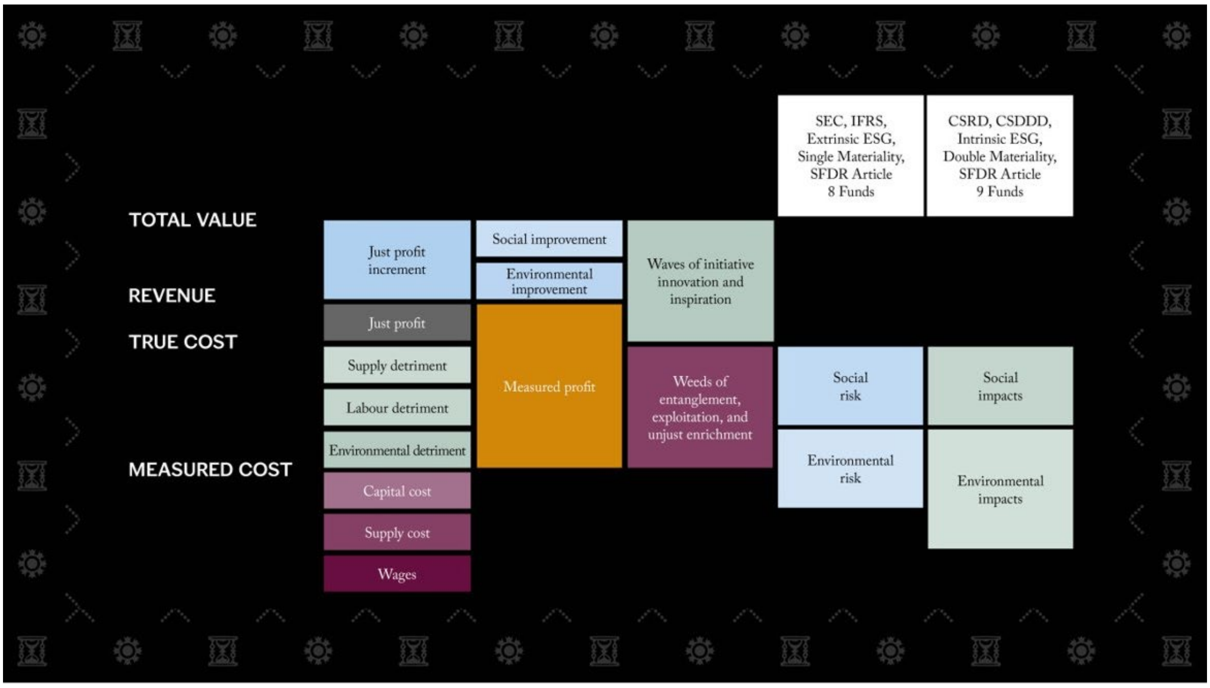
And the fifth letter, E is for exemplify, to bring the purpose to life through narratives and examples that illustrate what the company is doing in terms of delivering on its purpose and its success in doing that. But in particular, to also bring out the challenges and problems that it faces and the failures. Because what is absolutely critical in this game is to be authentic. And that means that one really has to demonstrate that the board of the company in particular, but the whole of the management, has a belief in that corporate purpose and is acting on it.

I want to illustrate this with another example which comes from the banking industry of what has been one of the most successful and fastest growing banks in the UK over the past decade. It's been a bank that has one of the best capital adequacy ratios, liquidity ratios. It needed no bailing out during the financial crisis. And it's also been highly profitable. It's a bank with the highest level, pretty regularly, of customer satisfaction of any of the banks in the UK. And it's also got very loyal customers, which brings out an important element of reciprocity. But if you look after your customers or your employees, then they look after you as a business. But it's not a British bank. It's the Swedish bank, Handelsbanken. And what's interesting about this bank is the way in which it governs its activities.

Traditionally, the way in which we look at or the way in which companies and banks run their activities is in a very hierarchical fashion from the top. And increasingly so, as regulation has imposed demands, on senior management and the board to oversee the risks of banks. What Handelsbanken did, starting in the 1970s, was to precisely invert that structure, to delegate authority from the board down to the branches of the bank. And the way in which it was able to delegate that authority and to put trust into people lower down the organisation was to ensure that there was an alignment of the values and the culture of the business, of the bank, with its purpose. And it produces a document, and it really instils that document called Our Way regarding what those cultures what the culture and the values are.

In addition, it has a particularly distinctive remuneration structure. Remember how we're always told that you have to pay bonuses to bankers because if you don't pay bonuses, you can't recruit them and you can't retain them. Well, here's a bank that pays its bankers no bonuses until they retire at the age of 60, at which stage they have a share in the profit-sharing scheme with the bank. It's a very long-term incentive scheme. But it brings out the fact that actually the importance of that is it provides a better alignment between the interests of those working in the bank and the interests of those customers that the bank wants to support and in particular its corporate customers and in particular its small and medium sised enterprise.

Because what it allows the branches to do is to build up relationships with their corporate customers where the branches do not have to refer decisions up, wait for his decision to come back down, and then tell the customer, I'm terribly sorry, you can't have the loan that you've asked for. They can take decisions about a whole series of things that a conventional bank cannot. And that allows the company essentially to create a traditional relationship, almost a local relationship type bank in the context of a large multi-national organisation. That, I think, illustrates very well what one means when one says conferring a sense of ownership of people in the organisation and ensuring that there's also an alignment of the remuneration structure. That is to say, in this case, that the bonus structure does not get in the way and encourage the personnel in the bank simply to try to act on a transactional basis of selling products at the highest price to generate the greatest short-term profit.

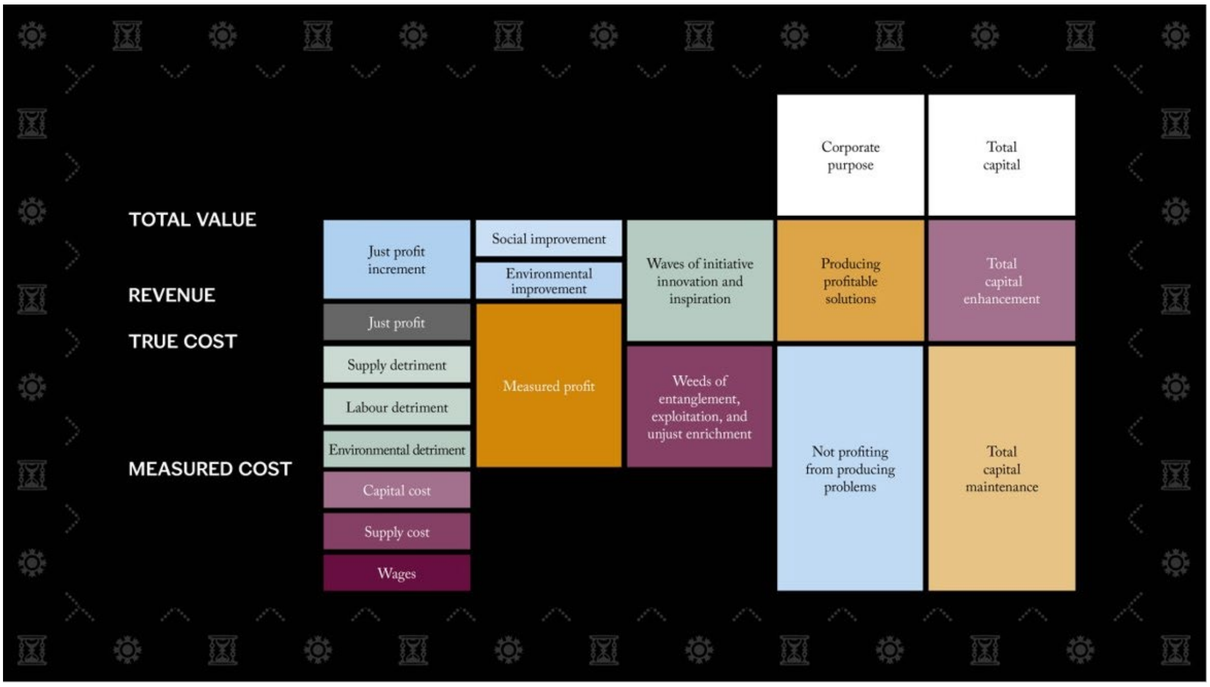


Now, critical to all of this is clearly the way in which one measures the performance of companies and financial institutions. And there's been a great deal of work that has been going on in this area, and in particular, over the last few years, there have been a large number of international initiatives in terms of measurement. These have been around the concept of sustainability. And sustainability is one of those terms which appears to be a very compelling notion, but actually is a very confused notion. And associated with that confusion is a confusion around the whole of the ESG agenda and the reason why it's been thoroughly and quite correctly discredited over the last few years.

The confusion is essentially a straightforward cause and effect problem. Namely, the way in which most people interpret sustainability when they work in companies in the financial sector. And the way in which one of the most significant international initiatives that is currently being taken interprets this. Namely, the International Financial Reporting Standards Foundation, IFRS, is in terms of the impact that environment and society and regulation and things like that have on companies and the risk of companies and therefore the risk of investors. That is what is sometimes termed an extrinsic form of ESG or a single materiality measure of the effect of environment and society. It's the impact on the risk from the perspective of investors. It's, in other words, essentially just another risk category of investment.

Now that is very different from what many people think that ESG measurement is doing or is supposed to be doing, which is exactly the reverse causality. That is to say, what is the impact that the company is having on the environment and on society, et cetera. And that's the approach basically that the European Union has taken in terms of the various directives that it's brought out, corporate sustainability reporting directive, the CSRD, corporate sustainability due diligence directive, CSDDD, and all the other various names and titles that are put to these initiatives. And what that seeks to do is to say, what is the impact that companies have on the risks that they impose on the environment, on society, and on individuals? So that companies are supposed to report on, for example, the extent to which they are embracing or violating human rights in their supply chains, the extent to which they are imposing environmental in the process of their activity.

Now you might think, well that actually gets a little bit closer to what one is trying to do, but actually what this is doing is introduce a great deal of additional confusion. Because it's essentially trying to place far too much weight on measurement in terms of what standard measures can do when in fact the relevant measures are very much those at the individual company, not some things that you can standardise at an international level. Furthermore, what this is doing is basically to raise the costs of companies and therefore companies in Europe are very concerned that they're not going to be able to compete on an international level once these forms of reporting are introduced. And thirdly and most significantly, it's all too damned complex. People just cannot grasp, understand the significance of these differences between extrinsic and intrinsic and single materiality and double materiality. It's gobbledygook to most people.



We need something that is much more straightforward and simpler that people can grasp. And what I suggest to you is that the notion of a purpose of not profiting from imposing detriment is something that everyone can grasp. Profit without harm is basically the bottom-line measure. And people quite reasonably think that that is what companies are doing or should be doing. That's why there's the outrage when you discover that they're not. And to do that, they should incur the costs of doing that. And they should measure the cost in a very straightforward, the most basic form of accounting, namely cost accounting way of ensuring that they are actually reflecting that in their measured profits and incurring the true costs.

Now you might say, well, okay, this all sounds very well, but it does sound a bit like pie in the sky, wishful thinking, academic dreaming that we could ever get to this. But I'd just like to say that actually, this is not only practical, it's not only that it's happening, and companies are doing this, it's actually been going on for a long period of time. In 1936, Henry Wellcome sold his, or gave his company, I shouldn't say sold, gave his company not to his heirs, his children, but he put it in a foundation. And the Wellcome Foundation, which then became the Wellcome Trust, grew to become one of the largest charitable foundations in the world and has basically become the saviour of British science and medical research in this country.

And his company, the Wellcome Pharmaceutical Company, thrived over the subsequent 40 or 50 years until in 1986, the Wellcome Foundation began to sell shares in the Wellcome Pharmaceutical Company. And in 1996, it sold its final block of shares to Glaxo to form Glaxo Wellcome that then merged with Smith Kline Beecham in 2000 to form GlaxoSmithKline GSK, a successful British pharmaceutical company. Now the importance of this is that the Wellcome Foundation and company is an example of what is termed an enterprise foundation. That is to say lots of companies have foundations for charitable purposes, but what this is an example of is a company that is actually owned by a charitable foundation. And there's one country in the world where there is a greater prevalence of these enterprise foundations than anywhere else.

It's a country that happens to be one of the highest levels of GDP per capita, one of the lowest levels of inequality, one of the best employee relations, and one of the happiest countries in the world. And it also happens to have the company which has now got the largest stock market capitalisation of any company in Europe. The country is Denmark, where some 50% of the stock market value of the Danish stock market is accounted for by these enterprise foundations. And the company is Novo Nordisk. That company, Novo Nordisk, which I was talking about earlier on, has just overtaken LVMH as the company with the largest stock market capitalisation in Europe. And the reason why it's done that is that in the process of trying to find ways of helping people treat type 2 diabetes, it of course realised that a critical element was diet. And so, it stumbled across a drug which is now called Wegovy, a drug for losing weight, which has become a blockbuster and propelled Novo Nordisk into the top ranks of market capitalisation.

Now, what has allowed Denmark to really achieve this outcome in terms of its success is that it has a system essentially of corporate law, which is called enterprise foundation law, which ensures that the foundations perform their purpose, that they're essentially engaged investors in upholding the purposes that the founders of the businesses wanted to be upheld and therefore used the foundation to ensure were upheld.

And it's also a form of law which ensures that the foundations, the owners do not exploit their privileged position of being a charity and act in the social interest. Now, what I think this emphasises very clearly is the notion that there are several elements associated with what it takes to really create a purposeful business and one that is designed and organised to solve major problems in a profitable fashion.

I've talked to you briefly about some of those elements in relation to law and ownership, in relation to governance and measurement. There are many others which I discuss in my book, and I would like to be able to cover, but I'm afraid I've run out of time and all I can do is therefore ask you to please read the book. Thank you.

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Mayer, Colin, *Capitalism and Crises: How to Fix Them* (Oxford, 2024; online edn, Oxford Academic, 23 Nov. 2023), https://doi.org/10.1093/oso/9780198887942.001.0001