The Centre for Enterprise, Markets and Ethics

Enterprise and Values series

Making Capitalism Work for Everyone

Volume 2 – Practical responses

Edited by Richard Turnbull and Tim Weinhold

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The Centre for Enterprise, Markets and Ethics

We are a think tank based in Oxford that seeks to promote an enterprise, market economy built on ethical foundations.

We undertake research on the interface of Christian theology, economics and business.

Our aim is to argue the case for an economy that generates wealth, employment, innovation and enterprise within a framework of calling, integrity, values and ethical behaviour leading to the transformation of the business enterprise and contributing to the relief of poverty.

We publish a range of material, hold events and conferences, undertake research projects and speak and teach in the areas with which we are concerned.

We are independent and a registered charity entirely dependent on donations for our work.

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For further information please contact the Director, Richard Turnbull, at:

The Centre for Enterprise, Markets and Ethics
First Floor, 31 Beaumont Street, Oxford, OX1 2NP

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List of contributors

Richard Turnbull

Revd Dr Richard Turnbull is the Director of the Centre for Enterprise, Markets and Ethics, Oxford. Richard was previously Principal of Wycliffe Hall, Oxford. He is a Fellow of the Royal Historical Society.

Tim Weinhold

Tim Weinhold was Director of Faith and Business at Eventide Funds, a leading Christian mutual fund, from 2013 to 2017. Tim is also an adjunct faculty member at the School of Business, Government and Economics at Seattle Pacific University, Seattle. He is also a Fellow of the Centre for Enterprise, Markets and Ethics, Oxford.

Philip Booth

Dr Philip Booth is Director of Research and Public Engagement, Professor of Finance, Public Policy and Ethics, St Mary's University, Twickenham, and Senior Academic Fellow at the Institute of Economic Affairs, London.

Jeff Van Duzer

Dr Jeffrey Van Duzer is Provost of Seattle Pacific University, where he was previously Dean of the School of Business and Economics and Professor of Business Ethics and Business Law.

Rick Alexander

Rick Alexander is Head of Legal Policy at B Lab. Before coming to B Lab, he spent 26 years at Morris, Nichols, Arsht & Tunnell LLP as a corporate law attorney, including four years as managing partner. He remains counsel to the firm. He is based in the United States.

James Perry

James Perry co-founded Cook Food. James sits on the Advisory Council of Big Society Capital. He is also co-founder of B Lab UK, the charity co-ordinating 'B Corporation' activity in the UK – the movement that seeks to encourage business to incorporate social objectives into their constitutional documents. He is based in the United Kingdom.

Cécile Renouard

Dr Cécile Renouard researches in the Institute for Research and Education on Negotiation in Europe at the ESSEC Business School located in Cergy-Pontoise, north-west of Paris. She leads a programme on the societal performance of multinational corporations in developing countries and more specifically on oil companies in Nigeria.

Introduction

Richard Turnbull and Tim Weinhold

The global economy affects the everyday lives of millions of people. Through the economic system, goods and services are exchanged, jobs created, businesses founded, taxes levied and government services funded. And lives enriched.

However, too often the system seems fixed, either in favour of big corporations, or governments or individual powerful participants. Greed and exploitation seem to replace mutuality and participation. Consequently, extreme inequalities and injustices arise, structures develop that reinforce aspects of a 'broken system' and reward is disconnected from long-term performance. As a result, increasingly large numbers of people experience alienation from the economic system whereby not all share in the fruits and benefits of economic success.

Yet this global economic capitalist system, despite all its flaws, has delivered long-term reductions in levels of poverty through jobs, enterprise and freedom. The progress has been phenomenal in terms of global absolute poverty. We cannot simply set aside the principles of economic growth and trade. Similarly, it is unrealistic to think that some sort of utopian society is possible alongside freedom, individual enterprise and personal responsibility.

The question, then, is whether the economic system can be structured in such a way that all may benefit, not necessarily equally but certainly fairly. What would be the characteristics of such a system? Aspiration, enterprise and reward should certainly be prominent, but alongside responsibility and compassion. Similarly, such a system would encompass a business structure that ensures that good work and quality long-term jobs are seen as responsibilities alongside rewarding the providers of risk capital.

We have gathered together a wide range of authors to explore this question of *Making Capitalism Work for Everyone*. Our contributors do not share exactly the same perspective on economic or other matters. We do not claim 'to know' all the answers. We are critical friends of capitalism. We seek neither

utopia nor unrealistic redistributive taxation. We want to encourage wealth creation.

However, we do believe that the only effective way to ensure a prosperous economic future is a system in which all have the opportunity to succeed, all are able to participate on fair terms and all can share in just economic rewards. Similarly, we advocate a global economy in which concepts of justice and fairness shape the system. For some of us the motivations will come from a faith perspective, for others, from human values more widely.

In our first volume the contributors reflected on the principles and challenges faced by capitalism. This second volume explores practical approaches.[1]

We are deeply grateful to the Centre for Enterprise, Markets and Ethics, an Oxford-based think tank dedicated to an ethical enterprise economy for sponsoring and publishing this work.

Your two editors are delighted to have formed a close friendship as well as a professional relationship, and we commend these chapters to you.

Notes

1. All the essays plus a number of others are available in an e-book available from the Centre for Enterprise, Markets and Ethics.

Chapter 1

Creating an Economy of Inclusion

Philip Booth

Introduction

Christian religious leaders are not known for their sympathy towards a market economy. They frequently complain about injustices and inequalities that they argue are caused by markets. Sometimes supporters of a market economy respond by conceding ground; at other times, however, by arguing that we have not got a real market economy, and need less state intervention, not more. Such a response was common, for example, when critics of markets blamed the banking crisis on a lack of government regulation of banks. It was to point out that the government regulation of banks that did exist, together with safety nets for banks that behaved recklessly, were among the causes of the crisis. This kind of response often seems inadequate and rather like the responses of die-hard communists after the fall of the Berlin Wall, who argued that real communism had not been tried and that they just wanted another go.

Such arguments are difficult to settle. We have theoretical and some empirical evidence, but often it is context-specific and hard to interpret unequivocally. A lack of counterfactuals – that is, evidence that something would not occur – is always a problem in making economic evaluations. However, there are many economic problems – especially those that cause dire poverty – that are demonstrably not the result of markets but of their absence. It is not that markets have been found wanting, it is that injustices have prevented access to markets. Those injustices might be in the form of deliberate policies that lead to the exclusion of people from markets, or governments not undertaking their proper functions of maintaining the rule of law, operating efficient and incorrupt court systems and ensuring that property rights are legally recognised and enforced. In such cases, surely it is not appropriate to criticise markets, rather the political forces that perpetuate the exclusion of people from them.

‘Injustices have prevented access to markets’

Excluded by or excluded from?

Pope Francis' statements on economics have often suggested that he believes people are excluded by markets. For example, in his Apostolic exhortation *Evangelii Gaudium*, he wrote: 'Just as the commandment "Thou shalt not kill" sets a clear limit in order to safeguard the value of human life, today we also have to say "thou shalt not" to an economy of exclusion.'[1] In the following paragraphs (53–60), the Pope seemed to blame market economies for the 'economy of exclusion', listing consumerism, debt, financialisation, 'trickle-down' theories and the profit motive among other reasons for the desperate poverty and inequality that exists in some places. The question did not seem to be raised as to whether the problem was a somewhat different one. Is it perhaps possible that various interests have conspired to ensure that people are not so much excluded by markets as excluded from markets?

This might happen as a result of malfunctional and dysfunctional government, possibly working in collaboration with business interests to promote monopolies, prevent land rights being established or collude in perpetuating corrupt processes that lie at the heart of much economic exclusion and the concentration of economic power.

These problems are common in Central and South America, the home continent, of course, of Pope Francis. Indeed, one of the right-hand men of Pope Francis, Cardinal Rodríguez of Honduras, illustrates the opposing points of view well. He has made statements that are similar to those of the Pope. For example, he has written: 'In this time the free market has produced one sector which is booming: social exclusion.'[2] As it happens, in 2008–14, the period to which he was referring, there had been a continuation of the very rapid decline in world poverty and a continued narrowing of the world's income distribution. Poverty has fallen because countries have become more open to trade and adopted systems of governance that are somewhat more supportive of the rule of law, private property, the proper administration of justice and so on. Putting that aside, however, this statement again raises the question of whether people are excluded by markets or excluded from markets.

The Cardinal's own home country helps illuminate this particular point. Those who are 'excluded' in Honduras – one of the continent's poorest

countries – do not suffer because of free markets but because of the cronyism, corruption and absence of the basic conditions for markets to function. Indeed, if one were to look for an absence of social exclusion in the continent, one would probably look to Chile, which is the most economically free country in Central and South America and has a tiny percentage of people living in absolute poverty. Honduras, on the other hand, is the 112th freest country in the world and has a quarter of its people living in absolute poverty. According to the World Bank's ease of doing business report, Honduras is the 162nd (out of 189) easiest place in the world to start a business. In Honduras, as in many other places in the world, people are most certainly excluded *from* markets and not *by* them. They may well be excluded by business interest groups and governments working together, but such places are not the type of market economy Pope John Paul II had in mind when he wrote in *Centesimus Annus*: 'Is this [capitalism] the model which ought to be proposed to the countries of the Third World which are searching for the path to true economic and civil progress?'[3]

The answer is obviously complex. If by 'capitalism' is meant an economic system that recognises the fundamental and positive role of business, the market, private property and the resulting responsibility for the means of production, as well as free human creativity in the economic sector, then the answer is certainly in the affirmative, even though it would perhaps be more appropriate to speak of a 'business economy', 'market economy' or simply 'free economy'.

Pope John Paul also made a reference to the importance of a free economy being supported by appropriate structures of governance when he said:

> But if by 'capitalism' is meant a system in which freedom in the economic sector is not circumscribed within a strong juridical framework which places it at the service of human freedom in its totality, and which sees it as a particular aspect of that freedom, the core of which is ethical and religious, then the reply is certainly negative. (42)

This does not mean that a market economy should be wrapped up in government regulation. But if an economy is not to be an economy that excludes, then people need to be able to obtain redress in law when contracts are not adhered to, property rights need to be respected and so on. A free economy should also be reasonably free from corruption. Without that, the strong will dominate the weak and there will indeed be an economy of exclusion.

A situation in which there is an absence of secure property rights and without a straightforward means for businesses to legally register prevents proper business contracts developing, leads to reduced opportunities for entrepreneurship, prevents capital secured on property from being invested within businesses, leads to corrupt legal and governmental systems and can lead to 'mafia gangs' dominating a business economy. New businesses cannot develop, expand and advertise in case they come to the attention of the authorities. Employment relationships often remain informal because legally enforceable contracts cannot develop, and so on. Such an economy is one in which established and powerful interests and those with connections have an in-built advantage.

'A free economy should also be reasonably free from corruption'

As the World Bank puts it in relation to the legal barriers to establishing businesses:

> A growing body of empirical research has explored the links between business entry regulation and social and economic outcomes. Where formal entrepreneurship is higher, job creation and economic growth also tend to be higher ... Conversely, excessively cumbersome regulation of start-up is associated with higher levels of corruption and informality.[4]

Perhaps unsurprisingly, there is a strong relationship between government institutions and economic growth. James Gwartney and Robert Lawson have studied data relating to the legal systems of 100 countries between 1980 and 2000.[5] They were rated according to the criteria established by the Fraser Institute's Economic Freedom of the World index. This includes factors such as the rule of law, protection of property rights and the enforcement of contracts. The top 24 countries had an average GDP per capita of $25,716 at the end of the period, and average economic growth of 2.5 per cent. The bottom 21 countries had an average income of $3,094 per capita and average economic growth of 0.33 per cent.

An economy of inclusion needs good institutions to allow markets to flourish. Generally, though not in all circumstances, governments have an important role in supporting such institutions. Their very purpose is to protect the weak from the strong. A market cannot be thought of as 'free' unless the institutions exist to ensure that agreed contracts are adhered to, property rights are respected, the administration of justice is upheld and so on.

Insider–outsider economies of exclusion in the West

It is easy to point to institutional factors in poor countries that indicate why an 'economy of exclusion' may exist. We might assume that such an economy of exclusion would not exist in the West where it is perceived that structures of governance are much more effective. This may be so in general, though there are some Western countries that do have poor institutions.

While the problems discussed below are less likely to be a matter of life and death, in many Western countries the actions of government can create an economy of exclusion. In continental Europe, the most obvious way this arises is from labour market regulation that has a tendency to create what economists call 'insider–outsider' labour markets, whereby some have secure jobs but others – the long-term unemployed, the young and older workers – are trapped outside with little prospect of obtaining a job.[6] In Spain, for example, only 17 per cent of young people have a permanent, full-time job.

While this figure has varied with the strength of Spain's economy, extremely poor employment levels among vulnerable groups has been a permanent feature of an economy in which the risks of employment decisions are raised by various forms of regulation.

While there are tangible forms of exclusion in labour markets in the UK, and while many people may feel insecure in their employment,[7] we do not experience anything on the scale of youth or long-term unemployment prevalent in southern Europe. What is common, though, are low income levels among households with at least one adult in work.[8] There are certainly problems with the way the statistics used to illustrate this problem are compiled and exploited, and especially with the way in-work poverty and out-of-work poverty are compared.[9] However, that there are some groups who have suffered from low income growth and have very little financial resilience at times of misfortune is difficult to deny. This is one of many reasons why the use of food banks has increased in recent years.

Proposals to deal with such problems almost always focus on welfare systems. However, Pope Francis has said that welfare is not a long-term solution to poverty. The question we face is why so many people in a prosperous country struggle to earn sufficient to meet basic needs while having enough left over to put money aside to save for retirement and for a rainy day.

Kristian Niemietz suggests a wide-ranging process of economic reform that could address such problems.[10] This would include reform of the Common Agricultural Policy, reform of energy policy and the liberalisation of land-use planning laws. These reforms, together with reform in one or two other areas, could add around £750 a month to the household incomes of the least well off.

Of course, all governments use policies that reduce household real incomes in the pursuit of other goals. For example, the regulation of energy markets could be justified on the ground that it reduces carbon emissions and that such reduction brings about long-term benefits that more than justify the costs. However, one area in which the costs of policy are almost certainly overwhelmingly greater than any benefits is land-use planning controls. By a big margin these are the most significant cause of additional costs

on households that arise from government regulation in the UK. Also, such controls have the characteristic of specifically excluding people from markets. They are part of the 'economy of exclusion' in many parts of the developed world, but especially the UK.

There are many statistics that illustrate the impact of the problem. For example, according to Countrywide, the average 20–29 year old will spend about half their post-tax income on rent for a one-bedroomed property.[11] According to UK government (ONS) figures published in 2015, the ratio of median monthly rent to median monthly salaries in Westminster – the most expensive area of the country – was over 78 per cent. Also, 18 London boroughs were among 25 areas in which the rent to income ratio was over 50 per cent.[12] The ratio of house prices to average earnings in the UK is 5.89.[13] This does, of course, disguise huge regional variations, with much higher figures in the south-east of England and London. The UK also has among the smallest dwellings in Europe.[14] Furthermore, the housing stock is of poor quality, with many people living in accommodation that is inadequate by modern standards.

The UK is an outlier when it comes to the problem of housing costs, and it is a problem driven entirely by a policy that prevents the building of houses. The issue is not lack of social housing – the UK has the third-highest level of social housing in Europe. In other words, the problem is not lack of government activity. Rather, the government has created an 'economy of exclusion' by adopting a policy that prevents houses from being built and therefore raises the cost of housing dramatically. This situation, it should be noted, is not a natural consequence of the UK's relatively high population density. If the regions of Switzerland, Belgium, Germany, Holland and the UK are ranked by their density (excluding single conurbations), no UK region appears in the top ten. Indeed, less than 5 per cent of the south-east of England comprises buildings or transport infrastructure.[15]

People are literally excluded from the housing market by prohibitions on building; they are prevented by the cost of housing from moving from areas of high unemployment to areas of low unemployment or from areas of low wages to areas of high wages; high land prices lead to higher business costs and less business competition, thus raising other household costs; and the

least well off are prevented from having dignified housing and attaining a level of disposable income, after housing costs, that allows them to buy other necessities and have some money left over to save for times of greater need.

The effect of land-use planning policies on the least well off has been enormous. Between 1971 and 2011, median house prices rose more than threefold relative to inflation. During this time, the ratio of house prices at the bottom end of the market (i.e. house prices in the lowest quartile) to incomes in the lowest quartile has risen from 3.2 to 5.7 in the East Midlands; 3.9 to 9.0 in London; 4.2 to 8.2 in the south-east. Bottom quartile house prices relative to bottom quartile incomes in the region with the lowest ratio today (the north-east) are higher than bottom quartile house prices relative to bottom quartile incomes in the region with the highest ratio (the south-east) in 1997. In other words, it was easier for somebody on a low income to buy a house in London in 1997 than it is for somebody on a low income to buy a house in the north-east today. Of course, house prices directly affect rents charged to those who choose not or are not able to own their own house.

'The effect of high house prices on the disposable incomes of the poor is dramatic'

The effect of high house prices on the disposable incomes of the poor is dramatic. Real incomes before housing costs for those at the tenth percentile of the income distribution grew by 80 per cent between 1965 and 2009. However, incomes after housing costs grew by only 45 per cent over the same period. In other words, had housing costs grown only at the same rate as incomes between 1965 and 2009, low income families would now have a level of real income 26 per cent higher. It is not only the least well off, of course, who have suffered from this rise in housing costs, but they feel the problem most acutely.

An economy of inclusion that allowed more housing to be built would not involve 'paving over the countryside'. As has been noted above, only a relatively small proportion of the country is used for housing or

infrastructure. Housebuilding is at very low levels in the UK because of the difficulty of obtaining planning permissions. It is at especially low levels in places where demand is greatest. In the UK, new dwelling starts have ranged from 331,000 in 1970 to 119,000 in 2008, with a strong long-term decline; that is, peaks generally being lower than earlier peaks and troughs being lower than earlier troughs. In Germany, new housing starts have ranged from 810,000 to 179,000 in the same period. Only 8 per cent of all housing finance in Germany comes from government sources: the grant of planning permission for a piece of land raises its value to such an extent that government funding is not necessary.

Conclusion

When Pope Francis and others criticise a market economy, there is little doubt about the power of the points they are making in the eyes of opinion formers. However, it is possible that, in analysing these problems, we are holding the telescope to our eyes the wrong way round. In the last 20–30 years the 'economy that kills' – to use Pope Francis' words – marked by the increasing globalisation of trade, of which he is critical, has led more or less directly to the most rapid reduction in poverty in the history of the planet. But there is a problem. Still many hundreds of millions are desperately poor. In the West, many people are poor relative to the level of prosperity to which they might aspire. But what is the problem? Are they excluded by markets or from markets? Of course, it is true that some people have to be – and should be – supported because they cannot meet their own needs by working in a market economy alone. Such people need support, whether from family, civil society, charity or government. They should be treated with compassion and justice. However, there are also huge numbers of people who are excluded from the market economy as a result of the failure of government to provide its basic functions in an incorrupt way. In the West there are many more people who experience less prosperity than they should because governments place obstacles in their way.

We can argue about the appropriate role for government in the lives of such people and whether it needs to provide healthcare, education, training,

basic health and safety regulation, welfare and so on. However, the most rapid way to successfully lift many more people out of absolute poverty in poor countries and relative poverty in rich countries would be to remove the obstacles to their participation in markets.

It should not be thought that business – or the private sector in other respects – is necessarily a benign actor here. The crony capitalism that Pope Francis knows so well from South America is often responsible for problems in poorer countries. Businesses can use the levers of government to pursue their own interests, acting alongside governments to create an 'economy of exclusion'. Nevertheless, the problem is exclusion *from* markets and not exclusion *by* markets. In the West it is often private-sector trades-union interests that favour the labour market regulation that causes problems for 'outsiders' in labour markets, and often large firms accept such regulation because it reduces competition. Certainly it is private interests in the UK – normally well-off householders – who support strict land-use planning regulation.

This exclusion from markets does not help promote the common good and it leaves many people struggling on the margins of society. Governments should, through rooting out corruption and performing their basic functions properly, as well as by removing impediments to economic development, promote a climate that leads to a more inclusive economy. However, this also relies on private interests that operate through the political process – whether by lobbying or choosing which factors motivate their voting – putting their own interests aside and supporting policies that nurture an economy that promotes human dignity and the common good.

Notes

1. Francis (2013), *Evangelii Gaudium*, paragraph 53.

2. See www.caritas.org/2014/09/family-time-economic-crisis.

3. John Paul II (1991), *Centesimus Annus*, paragraph 42.

4. See www.doingbusiness.org/data/exploretopics/starting-a-business/why-matters.

5. James Gwartney and Robert Lawson, 'What have we Learned from the Measurement Of Economic Freedom?', in Mark A. Wynne, Harvey Rosenblum and Robert L. Formaini (eds), *The Legacy of Milton and Rose Friedman's Free to Choose: Economic Liberalism at the Turn of the 21st Century*, Dallas, TX: Federal Reserve Bank of Dallas, 2004.

6. Indeed, it is interesting that economists use similar language ('outsider' labour markets) to Pope Francis' ('economy of exclusion'). However, they conclude differently. Most economists argue that labour-market regulation is a major cause of the problem, whereas Pope Francis has blamed unemployment – in Italy at least – on globalisation and people putting 'money' at the centre of economic activity.

7. This is often equated with zero-hours contracts, but in fact those on zero-hours contracts on average are as happy with their situation as those who are not.

8. See for example www.jrf.org.uk/data/work-poverty-levels.

9. See for example https://iea.org.uk/blog/how-the-poverty-figures-stack.

10. Kristian Niemietz, *Redefining the Poverty Debate: Why a War on Markets is no Substitute for a War on Poverty*, Research Monograph 67, London: Institute of Economic Affairs, 2012.

11. See www.countrywide.co.uk/news/countrywide-lettings-index-june-2016.

12. See www.ons.gov.uk/peoplepopulationandcommunity/housing/articles/housingsummarymeasuresanalysis/2015-08-05.

13. www.nationwide.co.uk/~/media/MainSite/documents/about/house-price-index/2016/Nov_2016.pdf.

14. See Malcolm Morgan and Heather Cruickshank, 'Quantifying the Extent of Space Shortages: English Dwellings', *Building Research and Information* 42:6, 2014, pp. 710–24.

15. The problem of housing costs is greatest in the south-east. However, the south-east is less densely built on than the West Midlands; and in Surrey (one of the most expensive areas for housing), more land is used for golf courses than housing.

Chapter 2

Purpose, Practice and Partnership: A Christian Reflection

Jeff Van Duzer

With apologies to Winston Churchill, it might be said that 'Capitalism is the worst form of an economic system, except for all the others.' Or putting it more positively, it seems beyond dispute that capitalism is the most efficient economic system for aligning the means of production with the desires of consumers (measured on a one-dollar-one-vote basis), *but that this outcome is only one aspect of human flourishing*.

The trouble comes when we forget this caveat. Often our idolatry of the free market leads us to conflate an efficient allocation system with an optimal overall societal outcome. Dazzled by the market's many positive and amazing features, we quickly go blind to competing values. In the midst of our ecstatic worship of all the good that the market has done it becomes too easy to ignore the human and environmental damage it has inflicted along the way.

Indeed, it is the very success of the market that tempts us to idolatry. An increased reliance on market economics has led to rising standards of living in most places around the globe. Extreme poverty has been radically reduced. The world attained the first Millennium Development Goal target – to cut the 1990 poverty rate in half by 2015 – five years ahead of schedule largely through the introduction of market-based economies in Asia.[1] Reductions in the poverty rate continue in all regions. Huge gains have been made in reducing infant mortality and extending life spans. The number of neonatal deaths around the globe declined from 5.1 million in 1990 to 2.7 million in 2015.[2] Market forces have spurred on substantial growth in food production, in most cases sufficient to accommodate huge growth in the overall world population.

'Reductions in the poverty rate continue in all regions'

In addition there is credible evidence to support the assertion that respect for the 'rule of law' goes up as businesses operating in a capitalist environment are established.[3] The market has accomplished much good.

Yet it has also done much harm. It can fairly be held responsible for multiple instances of environmental degradation and cultural commodification. It has nurtured a temptation towards greed and created a corporate environment in which leaders are confronted with enormous temptations to 'cross the line' in pursuit of profits. In many cases it has turned a blind eye to slavery, forced labour and sex trafficking. Moreover it has aggravated the gap between the rich and the poor. According to Oxfam, from 1980 through 2012 the percentage of income held by the richest 1 per cent in the USA has grown nearly 150 per cent. That small elite has received 95 per cent of wealth created since 2009, after the financial crisis, while the bottom 90 per cent of Americans have become poorer.[4]

For at least the last 15 years, the School of Business and Economics (now the School of Business, Government and Economics) at Seattle Pacific University has been wrestling with questions of business and economics from a Christian perspective. Generally, the focus of these discussions has been from the perspective of the business leader; that is, what advice would the School offer a Christian in business who seeks to align his or her behaviour with God's plans for the world? Under the broad heading of a 'theology of business', the School has been considering macro-level questions such as 'How might God think about the appropriate purpose of business?'; 'How might God want business as one institution in society to interact with other institutions?'; 'How might God think about the free market system?'

Our conclusion is that business leaders need to attend to questions of *purpose*, *practice* and *partnership*. In so doing they can participate in God's work in the world and help *make capitalism work for everyone*.

Purpose

In 2014, Miguel Padró, Senior Program Manager of the Business & Society Program for the Aspen Institute, released a paper entitled 'Unrealized Potential: Misconceptions about Corporate Purpose and New Opportunities for Business Education', which emerged from a series of Business & Society Program roundtables, meetings and private conversations with more than one hundred law and business scholars, corporate leaders and investors over the preceding three years. He wrote as follows:

> While corporations are arguably the world's most influential institutions, this influence is accompanied by deep public scepticism about the nature of the corporation, the motivations of its leadership, and its ability to advance the public good ...
>
> Such findings are sobering given the potential for our largest corporations to help solve the great challenges of our day, from developing and scaling clean energy to curing disease. Throughout history, the corporate form has been used for constructive and remarkably diverse purposes ... However, an equally powerful narrative of the corporation views it as an engine of income inequality and a threat to the sustainability of our natural environment and the civic institutions charged with protecting society's interests. Both of these narratives hold a fair share of truth and are deeply rooted in historical experience. And yet both assessments are incomplete on their own.
>
> Conventional wisdom unnecessarily constrains thinking about the role of corporations in the long-term health of society ...
>
> The dominant conception today is that corporations exist to maximize value for shareholders. Unfortunately, a particularly narrow understanding of this paradigm leaves many MBAs believing that they are *legally and morally obligated* to maximize stock price for their investors. Over three years of dialogue among and with scholars, business practitioners, and investors, we have observed deep concern that such a view is not only untrue as a matter of law, but unwise as a practical business matter. Unfortunately, the narrow paradigm persists strongly throughout business education and surprisingly little new thinking about corporate purpose has emerged from the business academy for some time.[5]

Against this backdrop, an alternative understanding of business purpose is desperately needed if we are to make capitalism work for more than just investors. Indeed, I would argue that the good corporations can accomplish in our world will be substantially enhanced if the dominant paradigm is turned upside down.

At this point, most corporations would affirm the importance of offering employees opportunities to engage in meaningful and creative work and of developing products and services that will enable their communities to flourish. These 'goals', however, are really understood as strategies designed to help achieve the higher end of maximising returns on shareholder investment. Providing good jobs reduces turnover and keeps expenses down. Providing good products builds brand loyalty and increases sales. In each case, these strategies serve the higher purpose of greater profitability.

However, in the light of the biblical narrative, this model is indeed upside down. Instead of adopting maximising return on investment (ROI) as the ultimate corporate purpose, we concluded that businesses' ultimate purpose would be better understood in terms of the following two goals:

1. Business exists to provide opportunities for individuals to express aspects of their identities in creative and meaningful work.
2. Business exists to provide goods and services that will enable the community to flourish.

I would argue that these are the proper first-order purposes of a business. Good profits – or ROI – is not the ultimate end of a business, rather it is the means of attracting the capital that the business needs in order to allow it to pursue its legitimate first-order purposes. Stated succinctly, profit is the means rather than the end of business operations.

'Profit is the means rather than the end of business operations'

Consider this metaphor: imagine that profit is like blood in our bodies. If you do not have blood circulating in your body we do not need to have a long discussion as to your purpose in life. You're dead. Similarly if profit is not circulating in a business we don't need to consider its purpose in society. It's bankrupt. But which of us gets up in the morning and decides to dedicate our day to the ultimate purpose of

pumping blood? No. Blood is critically important but it's not the purpose of our lives. And the same is true of profit in business.[6]

The blood metaphor does highlight one other critical characteristic of profit, however. In addition to serving as a means to a higher end, it also operates as a constraint. When a business leader sets out to achieve the twin goals of good jobs and good products, he or she cannot choose from any option that might advance these ends. Rather he or she must limit the options under consideration to those that can be pursued profitably. And in many contexts, this can be very limiting indeed.

Still under this proposed upside-down paradigm, the question to be pursued when making a strategic business decision is fundamentally different. Instead of asking which of the available options will most likely maximise ROI, the first question should be 'Which option can I pursue that will go the farthest towards creating opportunities for meaningful and creative work and providing the products and services most likely to enable my community to flourish?' These are fundamentally different questions and over time they will lead in different directions.

Practice

To understand a game one needs to have a clear understanding of both the object of the game (i.e. what it takes to win) and the rules (the limits of what you can do as you pursue the object). In the same fashion, reflecting on the discipline of business from a biblical perspective, if we are to understand God's design we will need a clear understanding of both the object – the purpose of the work – and an understanding of the 'rules' that a business leader should respect even as he or she pursues the purpose.

Put differently, the question is one of limits and boundary conditions. What limits should a business respect as it pursues the twin first-order purposes of good jobs and good products/services?

Just as there currently is a dominant understanding of business *purpose* – that is, maximising returns on shareholders' investments – there is also a conventional understanding of business *limits*. Put simply, under at least one

school of thought, a business leader has a fiduciary duty to do everything possible to optimise ROI *so long as it does not involve breaking the law*.

But does that mean it's all right for CEOs to maximise profits by following perfectly legal business practices that cross the line into unethical waters? Some business executives would say 'yes'. Their stance is that a CEO's main responsibility is to maximise profits and shareholder value within legal parameters – even if that means having low ethical standards:

> ... just because a decision may be viewed as ruthless, doesn't mean it's the wrong choice for the long-term viability of the organization. *When it comes to the game of business, my rule is to know the rules and then play the game at the very edge*.[7]

A competing view requires that business decisions be limited by both legal and ethical constraints. But even here, the understanding of ethics is often impoverished. For some, the two are conflated. For example, "'If it's legal, it's ethical" is a frequently heard slogan.'[8] For others, ethics may go beyond the law – but not too far. The patron saint of the 'maximise ROI' understanding of purpose, Dr Milton Friedman, explains the limitation this way in his seminal article, 'The Social Responsibility of a Business is to Increase its Profits':

> The responsibility is to conduct the business … to make as much money as possible while conforming to the basic rules of society, both those embodied in law and those embodied in ethical custom.[9]

While this seems to open the door to some restraints beyond just legal requirements, the balance of Friedman's article reveals how narrow this 'expansion' really is:

> There is one and only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.[10]

In short, for many, the dominant view holds that business choices are limited to law with perhaps a dash of ethics thrown in. From a Christian perspective, however, this is unsatisfactory. Christians are to aspire to be like God 'in true righteousness and holiness' (Ephesians 4.24), and while compliance with laws may, in most instances, serve as a floor for righteous behaviour it is certainly not the ceiling. So beyond mere compliance with laws, what additional ethical limits or boundary conditions should a business respect?

Of course, there are a number of sources for authority that one might refer to in answering this question. Biblically, however, I would suggest that there are two overarching principles that together capture God's higher standards for ethical limits. Both are derived from the biblical Creation account. As originally designed by God, human beings were made in the image of God (Genesis 1.27) and were called to function as God's stewards who would guard or take care of their environment (Genesis 2.15). Consequently, Christians in business have a duty to respect each individual as God's image bearer and a duty to operate their businesses in a sustainable fashion.

A duty to respect each individual's dignity in business dealings is relatively easy to understand, albeit sometimes difficult to put into practice. It involves encounters with individuals in every dimension of the business, such as customers, employees, colleagues and vendors. It implicates, among others, issues of integrity, privacy, freedom of expression, sexual harassment, racism, sexism, fair working conditions and reasonable pay. In each case the question to be asked is whether a contemplated business decision will honour the image of God in each individual who will be impacted by the decision.

Sustainability takes a little more explanation. Although this isn't perfect (for example, it doesn't work particularly well for businesses in extractive industries), 'sustainability' might be assessed by asking the following

question: 'If nothing changed in the external surroundings of a business, could it continue to practise business in this way for ever or, alternatively, is it using something up such that when it is gone, the business will have to change?'

In the USA, references to 'sustainability' are typically understood in terms of the natural environment, and certainly this is included. However, the concept has applicability across all dimensions of the business. Will the practice in question be sustainable in reference to shareholders? Employees? Vendors? Customers? And so on. For each of these stakeholders, principles of sustainability can be developed. For example, this is why a business must pay a risk-adjusted rate of return on invested shareholder's capital – not because doing so is the purpose of the business but because to do otherwise would be unsustainable. The business would burn through the invested capital with no opportunity to replenish.

Similarly, with respect to employees the principle of sustainability suggests that Christians should be at the leading edge of the 'living-wage' movement in the USA. For a business to use up the entire productive capacity of an individual but to fail to pay him or her an amount sufficient to survive on is fundamentally not sustainable. Comparable principles could be developed for the other categories of stakeholders.

The first-order purpose of business is to serve in two key dimensions: by providing goods and services that will enable the community to flourish and by providing opportunities for individuals to express aspects of their identities in meaningful and creative work. As businesses pursue these goals, however, they must select from the universe of possible choices only those that can be pursued in a manner that respects the dignity of each individual involved and is sustainable across all dimensions of the business.

Partnership

The institution of business was never intended to function in a vacuum. In God's design, business was intended to work in partnership with other institutions to enhance 'the common good'. Business and other institutions were to be allies working for a common purpose rather than adversaries

pursuing competing interests. While this applies to many different institutions, the relationship between business and government deserves special attention.

Notwithstanding a handful of public–private initiatives, most people in business and government experience the relationship between these institutions in adversarial terms. Government often approaches business as a wild animal that desperately needs to be controlled. To tame the beast it passes more and more laws and regulates business activities more and more closely. In its preoccupation with avoiding harm it frequently tramples on the important work of businesses as wealth creators. At its worst, it can substitute the judgement of politically motivated decision-makers in situations where attending to market signals would yield decisions more likely to nurture human flourishing.

‘Business was never intended to function in a vacuum’

At the same time, however, business frequently disrespects the role of government. Government involvement is characterised as a costly nuisance and distortion. Government bureaucracies are mocked as cesspools of inefficiency and its intrusions into the marketplace are to be resisted, subverted and avoided if at all possible.

Of course, neither of these positions honours the God-given purpose for government and for business. Neither was intended to function alone. Each needs the other. Government needs business. By itself it can never improve the overall financial health of its constituents. It needs business to create wealth and provide jobs. Moreover, government funds its operations from tax revenues – revenues only produced directly or indirectly by businesses.

However, business desperately needs government if it is to function in a manner that enhances the common good. In some ways this is obvious. Business needs laws and courts to enforce contracts. Businesses need police and firefighters to protect their facilities. They depend on government to provide the physical infrastructure, such as roads, needed to facilitate

commerce, and to fund the basic research that is often the wellspring of new innovation but too risky and costly for any one business to undertake.

Business also needs government to help ensure that the market functions appropriately. It is the government that enforces antitrust laws to prevent monopoly power from distorting the market. Government regulations capture externalities that individual businesses have incentives to avoid but which, once captured, allow the market to function more accurately. Governments require businesses to provide information that allows customers and investors to make better market decisions.

Government can help level the playing field between businesses by ensuring that they abide by a common set of ground rules. In some ways, the more ethical the business, the greater its appreciation for government regulation that forces its less ethical competitors to operate within a comparable cost structure.

When Alan Greenspan was questioned in the wake of the subprime mortgage meltdown about his previous opposition to government regulation of the financial industry, he noted: 'I made a mistake in presuming that the self-interest of organisations, specifically banks, is such that they were best capable of protecting shareholders and equity in the firms.'[11] It seems that government regulation is necessary, at times, just to preserve the health of the business.

Society's common good requires that goods and resources be fairly distributed. Fair distribution invokes two values that coexist in tension: distributing goods in respect of merit; and distributing goods equally. Merit-based distributions reward individuals for their ingenuity. They provide incentives for risk-taking and hard work. By and large, the market is a merit-based distribution mechanism. Government, by contrast, tends to function within a framework of equality.

Both are needed. Business creates wealth but, left to its own devices, will tend to distribute the wealth unevenly. Much of the growing income inequality that exists in our world today can be traced to this phenomenon. Government, on the other hand, does not create wealth but facilitates its redistribution

in a way that is designed to enhance equality. It does so through a variety of mechanisms including enforcement of labour laws, setting a minimum wage and enacting progressive taxation structures. Society flourishes best when there is a healthy balance between merit-based and equality-based distributions, and neither government nor business acting alone can achieve this balance.

So what might this mean for a Christian in business?

- In general the business person should interact with government as an ally in pursuit of the common goal of human flourishing rather than as an adversary. This change in perspective alone will open up significant opportunities for partnership.
- Business leaders should resist evaluating government in reference to business metrics. Efficiency is a central value of business. The capacity to produce more with less directly contributes to the business goal of wealth creation – providing goods and services that will enable the community to flourish. And, of course, there is no inherent value in an inefficient government. But government operates on a different ethic. Its goals and purposes are advanced through a political process of broad inclusion and compromise. These processes are inherently inefficient and yet central to government's vocation. It undercuts government's purpose when its output is critiqued against business standards.
- In some cases, Christians in business should support the enactment of regulations that would require all competitors to comply with a certain set of ethical standards. For the Christian in business who would be complying with these ethical standards in any event, regulation may help level the playing field. Of course, the desire to level the playing field must be weighed against the inevitable transaction costs of enforcement, reporting and monitoring compliance with new regulations, the reality that all regulations are inherently both over- and under-inclusive, and the risk of unintended consequences. It also must take into account the very real possibility that in the context of globalisation, a competitor may simply move to another jurisdiction.

- Christians in business should avoid using government to secure a competitive advantage in the marketplace. In his book *Supercapitalism*, Robert Reich describes a number of ways businesses have leveraged their political contributions to secure regulations that afford them an advantage over others in their industry.[12] In effect, these are cases where regulations are not being used to level the playing field but rather to tilt it in favour of the politically well-connected. This thwarts government's purpose of looking out for the welfare of all and undermines its capacity to partner for the common good.
- Business leaders operating within a regulatory structure will occasionally find gaps in the legal scaffolding. Conventional wisdom suggests that these are opportunities to be taken advantage of. But where the gap is clearly unintended or, as is sometimes the case in developing world countries, a function of a weak government, the business should work to strengthen the underlying regulatory scheme rather than take advantage of it in a way that would undermine the government's intentions.

In short, business needs government and government needs business. And society needs both of them to function as allies if they are to pursue the common good.

Conclusion

If business is to seek the common good – indeed if it is to work for everyone – it must redirect its efforts away from a narrow focus on maximising ROI towards business choices that will seek to profitably create meaningful jobs and good products. It must conduct it operations in ways that respect the fundamental dignity of each individual it touches and are sustainable across all of its stakeholders. And it must be willing to partner with government and other institutions in society, recognising that the common good depends on a set of institutions, serving different but complementary goals, working in tandem.

Notes

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Chapter 3

Benefit Companies – A Pathway to the Future

Rick Alexander and James Perry

The capital markets in the UK and many other countries are dominated by the doctrine of 'shareholder primacy'. Under this concept, investors – including pension funds – seek to have each company in which they invest 'maximise value' by creating the greatest returns to shareholders. Unfortunately this narrow view of value can create great costs to society – what economists call 'externalities'. Globally a tremendous amount of capital is subject to this system, encouraging the creation of systemic risks and costs. This phenomenon manifested itself in the recent financial crisis and is making it much more difficult to address climate change.

There is now a global movement to address this problem by passing 'benefit company' legislation. This corporate law reform gives companies the option to reject shareholder primacy and to be managed for the benefit of all stakeholders.

Problem identification illustrates the path to a solution

Business has become the most powerful force on the planet, and capitalism is the system under which we invest and steward business capital. The UK, to a substantial extent, invented the global system for allocating private capital. The community of institutional investors and their advisers wield as much power in allocating resources as any political system. Under shareholder primacy, this system of allocating financial capital ignores its effect on human and natural capital. Investors and businesses have not been asked to consider their effect on these essential elements of our economy. The investment and business community now have an opportunity to lead a reform of the principles that

'Business has become the most powerful force on the planet'

guide the investment channel, and to ensure that their beneficiaries' assets are used to create a prosperous and resilient society for those beneficiaries.

Recent advances in industry, technology and finance have rescued hundreds of millions of human beings from poverty and created opportunities for broad prosperity and human fulfilment never before imaginable. But these advances are challenged by systemic threats that cannot be addressed without modifying the global investing chain. There is an urgent need to do so.

The investing chain channels hundreds of trillions of pounds of capital to businesses around the world. This capital is largely controlled by institutional owners, including mutual funds, pension funds, insurance companies, sovereign wealth funds, endowments and foundations. These asset owners rely on professional asset managers to direct this money into a variety of investments, including shares and bonds of public and private companies.

This chain is the circulatory system of the global economy, and serves vital functions:

1. It allows savings for the future – individuals can save to buy a home, retire and pass wealth on to the next generation.
2. It allocates savings to investments in manufacturing, intellectual property and technology, which drives growth and progress.
3. It should also provide stewardship through the governance rights of owners.

The companies at the bottom of the chain should work for the beneficiaries at the top of the chain – the workers, pensioners, insureds, students and others. In theory the allocation and stewardship performed by the institutions and managers in the middle should serve the savers' interests. However, the system has become sclerotic, often working against the interests of those beneficiaries.

At the heart of our financial system there is a misalignment between the individual investor and society. What might be rational behaviour for an individual investor in his fiduciary context might be irrational behaviour for society. This misalignment arises from un-costed externalities. For example, executives recognise that there is no cost imposed on an individual company for emitting carbon. This creates an opportunity to increase returns by burning cheaper, dirtier fuel. While this may increase the individual company's share price, increasing global temperatures increases risk to the portfolios of all diversified investors – including a worker whose savings are invested in that company through a pension fund. For savers, this externalisation of costs:

- increases the financial risks borne by a diversified portfolio;
- increases the risk that their lives will be disrupted by the effects of climate change.

Therefore the system works against the interests of the savers because it is focused on raising investment returns one company at a time, and thus encourages the externalisation of costs. Asset owners seek to maximise the value of each asset in their portfolio, and reward asset managers for doing so. Those managers expect companies to whom they direct capital to maximise the return on their shares, and support executive compensation packages that reward increasing share prices. As a result, corporate executives are encouraged to make decisions orientated towards maximising the return on their shares, even when those decisions add risk to the diversified portfolios of their owners and create instability in the world in which those owners live.

Two phrases encapsulate this paradox:

- The first is 'modern portfolio theory', the investing paradigm that dominates portfolio management. MPT is a sound theory in many ways but its practical application has led institutional asset owners to focus on

'alpha' – returns that are higher than the return on a basket of similar assets – rather than on increasing (or at least not decreasing) the value of the basket.

- The second principle – 'shareholder primacy' – posits that directors of companies must seek to deliver the best returns they can to their shareholders, without regard to the effect of their decisions on any other asset the shareholders might own or any other aspect of their lives.

MPT and shareholder primacy came to prominence in the latter half of the last century, the capstone being case law including the *Revlon* decision in Delaware (1985), and *Harries v. The Church of England Commissioners* in the UK (1992). Both had the effect of establishing that fiduciary duty governing trustees and directors was to maximise the financial interests of shareholders. This principle was codified in the 2006 Companies Act in the UK.

These principles lead to corporate behaviour that focuses on short-term share price and ignores the interests of critical stakeholders. In response there is a serious movement to require companies to act more sustainably. This movement, however, treats the symptom – irresponsible corporate behaviour – without addressing the root cause: the systemic focus on the financial performance of companies. Thus for the most part this movement to focus on corporate social responsibility (CSR) or environmental, social and governance concerns (ESG) is couched within the frame of shareholder primacy and MPT. A current focus of the ESG movement is that by acting responsibly, companies can avoid risks to their own reputations and improve their own long-term viability, and that asset managers can be stewards who encourage such long-term responsible strategies.

This is an important idea – there are many opportunities for companies to improve financial performance by treating the rest of the world decently and by taking a long-term view of their own business that incorporates environment and social factors. But 'doing well by doing good' is simply not enough. As long as asset owners and managers focus on improving the financial performance of individual companies, corporate executives

will engage in less responsible strategies when available, and seek profit by imposing costs and risks on the rest of the market. And as long as asset managers are judged by their 'alpha', they will continue to be rewarded for finding the companies that beat the market by externalising costs and risks. We must shift the focus of the investing chain to creating the real value, meaning that companies must be given the opportunity to act in the interests of all stakeholders rather than exclusively for shareholders.

'companies must be given the opportunity to act in the interests of all stakeholders rather than exclusively for shareholders'

The ESG movement has demonstrated that companies can act more responsibly, but authentic change in this area must be driven by asset owners. Only they have the power to create fundamental change, by requiring managers to focus on real value rather than naked financial gain. For fiduciaries, the ultimate beneficiaries of the capital they manage are entitled to have their assets used in a way that preserves their financial future and the future of society and the planet on which we live. *The urgency of this task cannot be overstated: NGOs and governments simply do not have the resources to continue to repair the damage being done by an investing chain that encourages irresponsible and unsustainable capital deployment.*

Benefit company: introducing stakeholder values into the investment chain

At the company level there is an emerging global alternative to shareholder primacy, known as the benefit company. This creates stakeholder-based corporate governance by requiring directors to pursue positive-sum opportunities. The model has three mandatory elements: a broadened purpose, director accountability and stakeholder transparency. Companies can opt in with a simple amendment to their articles. The statute requires that directors of benefit companies balance the interests of stakeholders with those of shareholders. It has now been adopted in 32 US jurisdictions

(including Delaware), as well as Italy, and is being considered in other states and countries. Should current momentum be maintained, this legislation will de facto become the new global legal standard for businesses that are seeking to work for everyone.

Shareholders retain their rights – only they can enforce this obligation. Rather than undermining their rights, introducing director accountability for stakeholder interests gives shareholders and management a tool with which to engage cooperatively to address critical systemic issues without the obstacle of the 'shareholder primacy' mandate. Moreover, adopting benefit company governance helps a company to build more value for its own shareholders by allowing the company to make authentic commitments to its employees, customers and communities.

The legislation creates a voluntary regime. Business should not be forced to change. Stakeholder governance is rational and must demonstrate its superiority to shareholder primacy in a market environment.

The existing system is weighted against a stakeholder approach. Benefit company legislation simply offers stakeholder governance an equal opportunity. Culture and practice around shareholder primacy is a bar to investors using financial capital to build and preserve human and natural capital. The legal and accountancy professions are rooted in the orthodoxy of shareholder primacy. Understanding of the emerging alternative is sketchy and rudimentary at best. It is routinely seen as an improper route to pursue in light of modern understanding of 'fiduciary duty'.

The UK has the opportunity to create market infrastructure to enable companies to pursue this alternative path – should they wish to do so. By doing so, the UK can take leadership in the urgently needed evolution of capitalism – just as it did in centuries gone by when it to a large degree created a global trading economy.

Key elements of benefit company legislation

Providing for benefit company governance clearly creates and illuminates two alternative pathways for business: the default shareholder route or the emerging stakeholder route. Without establishing this in the statute,

shareholder primacy will remain as the only clear pathway for business, because the adoption of stakeholder governance without a statutory structure creates risk and uncertainty.

Under current law, companies can already change their charters to pursue impact, but the efficacy of such provisions is limited without a statutory structure. Benefit company legislation would create a simple turnkey solution for companies wanting to pursue and lock in commitment to stakeholders.

The protections built into the legislation allow companies to confidently adopt stakeholder governance without creating uncertainty or the risk of excessive litigation. By giving companies the confidence to pursue the interests of society and the environment, benefit company legislation reduces incentives to externalise costs, and consequently reduces the need for regulation. No company would be obliged to choose this legal form. The legislation would be an important tool for mainstream businesses pursuing commitment to stakeholders. And the reporting requirements ensure that a company reports annually on its stakeholder performance in addition to its financial performance.

Certified B Corporations: lighting the path towards a capitalism that works for everyone

Certified B Corporations are companies that have adopted the legal framework of the benefit company or a similar stakeholder-based governance model, and achieve a high level of performance for all stakeholders, as measured by the B Impact Assessment.

Certified B Corporations launched in 2007 in the USA, where arguably the problems associated with capitalism's failure to work for everyone are most acute. However, because the problem of an overly narrow focus for business is a global one, the idea has attracted interest from business leaders all over the world. There are now 2,000 B Corporations in 50 countries, working in 130 industries. They include some of the world's leading growth businesses, such as Etsy, Kickstarter, The Honest Company, Hootsuite and Warby Parker, as well as established brands such as Patagonia and Ben & Jerry's, and industry leaders such as Laureate Education (one of the world's

largest providers of higher education), Roshan (Afghanistan's largest mobile phone company) and Natura (Brazil's largest cosmetics company).

In September 2015 the movement launched in the UK, where there are now over a hundred B Corporations, including leading growth businesses such as Ella's Kitchen, Generation Investment Management, COOK, JoJo Maman Bébé, Escape the City and Ingeus.

Growth all across the world is accelerating as awareness of this alternative path for business grows, and as these B Corporations develop an evidence base that this path is value-creative for shareholders as well as for society.

The costs of moving to a stakeholder economy

Moving from shareholder values to stakeholder values will incur two types of costs: transitional costs and 'trade-off' costs. The former are the types of friction that would be expected with any significant public policy shift: the costs of creating new standards, of educating system participants and of implementation. These are hard to estimate but probably not large in comparison to the amount of capital currently allocated and the inefficiencies it seeks to address.

The trade-off costs are trickier but critical to the success of the stakeholder value movement. It is always tempting to argue that there are no trade-offs. This argument posits that because sustainable and responsible operations are inherently efficient and reputation-enhancing, they will always create long-term value for any firm. While it is often the case that responsible corporate behaviour does create long-term shareholder value, there will always be opportunities to create shareholder value irresponsibly. There are some important sustainability practices that just will not drop to a corporation's financial bottom line. The distinction between sustainability practices that are financially material and those that are not were discussed in a recent piece on shareholder activism from Professor George Serafeim at Harvard Business School.[1]

Thus some individual companies may miss opportunities to create more profit, and this can certainly be a significant non-recoverable 'cost' from

the individual company perspective. From a societal perspective, however, these foregone opportunities are negative sum, and the ultimate reason for encouraging a shift to stakeholder values in the capital markets is to create conditions in which we are applying our financial capital to positive-sum opportunities.

So the real challenge to implementing this shift will be avoiding the 'tragedy of the commons' that will always tempt both corporate and asset managers. Compensation will play a role, as will public perceptions and shareholder action at the level of ultimate beneficiaries.

The supply side

As a demand-side intervention, the benefit company creates a clear path for businesses and shareholders that wish to make their business work for everyone to follow. It is important to note that a range of complex supply-side interventions are required to provide the basis of a shift to enable capitalism to work for everyone. Many others, such as the Purposeful Company work of Big Innovation Centre in the UK, are seeking to illuminate how best to tackle the suite of interconnected issues that need to be resolved at both the investor level and in the real economy. While the benefit company can be a key lever to effect change at both levels, tackling the disconnection between the financial markets and the real economy will require a range of separate interventions.

Reasons to be hopeful

The growth in the number of businesses choosing to adopt the benefit company form is accelerating rapidly – in the USA there are now close to 4,500 benefit entities. More and more multinational companies are seeking to understand how they might adopt such purposes. In addition to this, over 50,000 companies worldwide are using the B Impact Assessment, the social and environmental performance management tool that offers one way for companies that adopt the benefit company status to fulfil their reporting requirements. Adoption of the legal form, and use of the B Impact Assessment, are both now experiencing exponential growth.

It is becoming increasingly clear to business leaders, governments and civil society that the current narrow role that business has been given is inadequate. Business can do more. There is growing consensus around the opportunity to address the design constraints of our current system of shareholder capitalism – to enable it to evolve into its more socially valuable and sustainable successor, stakeholder capitalism.

Notes

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Chapter 4

How to Make Finance Serve the Common Good

Cécile Renouard

Today, insurance companies and pension funds manage more than 100 trillion dollars of savings. These flows are not directed to long-term investments in low-carbon infrastructure and other sustainable development projects, but are fuelling financial bubbles; shareholders who lack investment opportunities in the context of a deepening crisis of the real economy are collecting increasingly disproportionate dividends, becoming sources of economic instability and social inequality. It is important to find a strategy for training financial analysts, and more generally managers, to ensure that they are neither clones nor chameleons. This strategy needs to meet professional and deontological standards that are indispensable to the economy and finance, and must take into account the economic and societal changes to be made. There have been many dramatic events in financial markets since 2007. The subprime crisis was followed by successive bank failures and numerous scandals (Madoff, Kerviel, UBS, Offshore Leaks, China Leaks, Luxembourg Leaks etc.). More generally, collusion between public and private interests, as well as the public discredit of elites generated by different scandals worldwide, have underlined the necessity of looking at the type of training that needs to be promoted in order to fight against fraudulent practices that undermine social ties. Such training also needs to take into account today's energy and ecological concerns.

The bankruptcy of Lehman Brothers

The bankruptcy of Lehman Brothers was declared on 15 September 2008, and was linked to the subprime crisis. The bank was facing important write-downs of its real estate investments and because it was unable to find a buyer, had to file for bankruptcy. It was an emblematic bankruptcy, which the US authorities wanted. But it was not alone. The implosion of the US financial system began with the near collapse of New Century Financial (April 2007). It led among other things to the buyout of Bear Stearns by J. P. Morgan, with support from the authorities (in March 2008), the refinancing of Fannie

Mae and Freddie Mac (during the summer of 2008), the purchase of Merrill Lynch by the Bank of America (September 2008), the bankruptcies of the insurance giant AIG, followed by that of the Japanese insurer Yamato Life (October 2008), the Royal Bank of Scotland (end 2008), the restructuring of UBS and the bankruptcy of the Irish State in the wake of Irish bank nationalisations, and so on.

This failure of financial institutions had both systemic causes but also very often resulted from the accumulation of risks that were not correctly controlled. The banks piled up commitments and investments, notably in the form of derivative products and securitised loans, which are little-regulated, 'sensitive' financial instruments. As a result they were carrying ever greater risks that could not be sufficiently 'reinsured' in the markets, even if the overall characteristics of such products did not stop them obtaining satisfactory assessments by the credit-rating agencies. It may therefore legitimately be asked whether risk control by such institutions really did seek to manage real commitments, rather than merely checking in a formal manner that banks' activities respected standardised procedures: for example, not buying stocks with at least a minimal rating.

The Kerviel scandal

In January 2008, news broke out in France that a trader in the banking, finance and investment division of the Société Générale had lost the bank €5 billion by speculating in stock markets. As with any trader negotiating futures contracts on stock indexes, Kerviel was operating under strict limits concerning his risk exposure, responsible to an ad hoc team whose function was to alert traders and their superiors about any breaching of limits. The aim was to ensure that positions taken were covered by symmetrical positions at the least, in order to return to risk levels permitted by the bank.

Several points may be noted. At the time, operating in the derivative markets was of strategic importance to Société Générale. People operating in these products had a not inconsiderable influence within the bank. By definition such traders are exposed: their transactions involve large sums that have

little relationship to reality (Kerviel had mobilised around €50 billion in his positions). Such traders live in a virtual world. Their pay is linked to profits. They are also subject to social pressures: a bank's networks, the atmosphere in the trading room, competition between market floors and even within a bank's trading room. Their egos are very strongly expressed. As a result, management of such traders is very important. However, the turnover that can be observed among 'heads' of teams of traders, who may switch from one bank to another, may lead to carelessness. This raises the issue of governance for each bank.

- Do all these financial actors actually master technically the sophisticated products they use?
- Has their human formation prepared them for such situations?
- Do the departments of control and management of financial risks within banks have the natural authority and technical competence to control traders' activities?
- How are those persons who use sophisticated products trained?
- What are the criteria for recruiting and selecting supervisors and traders?
- What criteria are used in organising their professional development?

Ethics training in business schools and universities

It should be noted that the initial academic training of bank managers over 50 today, who are in positions of responsibility, did not include theoretical teaching of the most sophisticated market techniques used now, and implemented by teams that report to them. They have therefore to be surrounded by department or unit heads who are younger and correctly trained in banking and insurance. They must also ensure that their teams have sufficient cultural diversity.

It also needs to be noted that present training in finance, mathematics and econometrics involves very little questioning of the social effects of the techniques put into place. It is, however, legitimate to subject practices that have developed over the last 30 years to critical examination of their wider social role. Yet the references of our societies are clearly changing. The issue of compensation reflects the change in paradigm. Income spreads between top and bottom earners that used to be seen as indecent are now justified as compensation for specific talent, for mastery of business or simply as chance. But how is it possible to justify from any ethical point of view income spreads of 1 to 400, or even 1 to 1,000 and 2,000, spreads that are scarcely affected by taxation? For market-driven finance, these issues are aggravated by the complexity of instruments used and the speed with which financiers invent procedures to circumvent regulatory constraints, and hence raise their chances of rapid winnings. The examples concerning the pathologies of finance are quite clear. Since the work carried out in 2009 relating to abusive securitisation practices, and the destabilising role of over-the-counter markets, new practices have emerged, such as high-frequency trading, dark pools and shadow banking. These were all accepted by an EU MiFID (Markets in Financial Instruments) Directive of 2007, which reduces possibilities of controlling markets even more. For the person in the street, the concerned citizen who is not a specialist, all of this amounts to no more than a series of damaging inventions, and the discussion about the so-called benefits of these practices demonstrates very clearly their social harmfulness. The justification does indeed seem to be limited to greed and the unbounded search for personal wealth by some. Yet when it comes to criticising such financial innovations and simply banning them, the silence is deafening on the part of financial market experts, while politicians are very reticent in their declarations. From this point of view, the banning of naked credit default swaps (CDSs) by the European Parliament in the autumn of 2011 was a real, though isolated, step forward. And it was outdated, given the permanent inventiveness of operators. This raises the question of how to get experts, financial operators and politicians to enter

> **‘The issue of compensation reflects the change in paradigm’**

into a dialogue. How can practitioners be trained to be incisively critical of the malfunctioning and pathologies of the system? The issue of how to regulate finance must be accompanied by a collective questioning of its basic soundness, and this has to be done in classrooms, within financial institutions themselves and in the public domain.

However, apart from training in finance, the whole direction of education in business professions needs to be re-examined. In general, actual training continues to be provided without systematically including any of the extra-financial concerns described in the previous proposals. A symptom of the gap between needs and dominant practices is the development in management schools of international associations (such as Net Impact or AIESEC), which seek to put strong emphasis on training in ethics and companies' social responsibilities. Such training, which students who are members of these associations are calling for, is not simply an afterthought or marginal. Instead, it strives to design whole curricula from a social and ethical point of view.

Business ethics as it is taught in certain programmes is very insufficient and partial, for several reasons. First, such training tends to be optional, reflecting its marginal character. Thus there is every chance that it only gets through to the 'converted'. Second, most theorists of business ethics are led to wanting to demonstrate the short- and long-term advantages of management that respects certain ethical practices, as well as the diverging interests of 'stakeholders'. They draw on case studies of ethical behaviour, which show that companies have everything to gain from acting morally. Yet such an instrumental perspective is seriously limited. On the one hand, in the short term there seems to be no clear link between a company's social and societal commitments and its financial performance.[1] Grounding the arguments for business ethics on its potential profitability is likely to lead only to limited mobilisation by companies and managers in favour of the unconditional respect of certain norms. It therefore seems necessary to present an applied ethics approach in companies from a different point of view. Different rationales and opposing, or even contradictory, interests exist in companies. An approach based on ethics involves highlighting these differences and seeking ways of moving to their resolution, subject to criteria that need to

be specified, such as the social utility of an activity, the refusal to do harm and so on.[2]

The teaching of business ethics, as we have seen, is marginal in courses taken by students. To be sure, things have evolved a little. A recent attempt is based on getting all actors in a firm's business activities to adopt a win–win perspective. The aim is to show how companies that target populations at the bottom of the social pyramid could increase both their market shares and be profitable, by allowing poor populations to have access to quality goods and services.[3] The ambiguities of such an approach are numerous and it is important to analyse case-by-case who really gains from a firm's social innovations. The aim is not to deny the efforts of certain groups striving to make business activity more civic, but to stress the limits of these strategies. For example, when the quality of a product made by a multinational is not really superior to a local product, then to what extent is it legitimate for the multinational to penetrate the new market, if this leads to a weakening of small local producers? In many cases, students at business schools would benefit from extending their learning to the ethical and political issues linked to their practices. This is not done in most cases.

The limits of the predominant referral to ethics in businesses

A further important fact to stress is the recurring difficulty that training in business and finance faces, in dealing with ethics, in both business schools and companies. Ethics tends to be associated with the compliance by individuals or organisations with existing standards and regulations. In the first instance, this means promoting respect for rules, and indeed many problems could have been avoided in certain banks had traders not taken positions that exceeded their authority. However, personal or even collective integrity in respecting the law should not be identified with morality. Actions that are legal are not necessarily legitimate. Many business and engineering schools and universities have a tendency to let themselves be trapped by what could be called 'the good student syndrome': the habit of obeying the rules of the game in education and then in work.[4] This may lead to a

successful but conformist career, with little scope for thinking critically, for identifying and challenging factors that generate inequality and exclusion or for commitment to fairer and more humanising practices.

The instrumentalisation of ethics is also strongly sustained in companies themselves in order to promote adherence by employees. There is a growing public questioning about the supposed virtues of companies' business, tax and civic practices and so on. In response, companies are seeking to develop stronger ethics internally, based on charters and codes of ethics. However, most of the time such an ethics-through-charters approach focuses on individual behaviour and not on the behaviour of companies as social organisations. In other words, this approach limits discussion of practices within companies to the issue of individual behaviour, as though legitimate questions could not be raised about the consequences of companies' behaviour as a whole. From this point of view it is important to recognise that explicit references to the Universal Declaration of Human Rights, the Principles of the ILO and the OECD Principles represents significant progress.

Furthermore, the proliferation of ethics charters leads to what very much looks like a partitioning of analysis. Charters have a tendency to refer all substantive issues an employee may consider as their responsibility to a third party, an expert within the company on this question: 'above all, our company must respect the law, and for any tax issue that you may face, any questions which you may be asked by representatives of government, you should first refer to the tax department, and so on'. The same is true about issues relating to communication, the environment and any other sensitive questions, so that ultimately the ability of individual employees to think about problems and discuss them with others is limited. To deal with this, some companies do set up ethics committees that allow certain issues to be discussed, at the behest of employees. This is more about transmitting information and appealing for arbitration, rather than reflecting on issues collectively.

The partitioning of analysis is also driven by the growing specialisation of profiles. In the name of the continual need to acquire high-level skills, there is a strong tendency among human resource personnel – such as recruiting

firms – to select employees who have the identical profile to their future superior, and who have identical training and experience to the requirements of the jobs offered. Such HR policies lead to a partitioning of professions, as well as a partitioning of individuals and their views about their work. In other words, no one has legitimacy when expressing views on work that does not relate exactly to the core of their own activity.

Thus a sales manager, whose job is exclusively to sell, has no legitimacy in commenting, for example, on the ethics of a firm's advertising, because views about this are the sole responsibility of the marketing and communication manager. To be sure, organisational efficiency means that not everyone can be involved in everything. However, it is argued here that concern for ethics is probably one of the subjects that could and should stand more at the crossroads of different functions within the company.

This partitioning of analysis and thinking is maintained by recruitment, which generally focuses on technical competencies at the expense of the ability to think more generally, and a general culture, as shown for instance by the limited recruitment of graduates in humanities (sociology, philosophy etc.). Moreover, it is often difficult to move from one function to another within the company. For all these reasons, though 'vertical' ambition is accepted, mobility from profession to profession is de facto complicated. Yet if all accountants do not necessarily have the temperament to work in sales, nothing prevents some of them from having relational qualities that could allow them to carry out jobs not strictly limited to financial techniques.

'There should be generalised training in ethics in higher education'

A greater permeability of professions to outsiders, as well as to non-specialist training, would surely help in promoting company consideration and analysis of ethics. Therefore there should be generalised training in ethics in higher education. To foster a critical perspective among students and professionals in the business and financial worlds, in order to make progress towards equitable and sustainable practices, there should be:

- a generalised and compulsory course in moral and political philosophy in each curriculum;
- systematic incorporation of work on codes of good conduct and professional ethics in all programmes;
- mandatory blue-collar traineeships and immersion in a developing country in all educational tracks;
- support for continuing training of managers in ethics and alternative experiences (solidarity leave etc.).

It must be stressed that if the training of financial operators and analysts is better organised, including training in economics and social ethics, as well as internships in a company, then this will only be beneficial if clear professional ethics are adopted in institutions that recruit employees and manage their careers.

Finally, to move to a sustainable economy it is important to favour technical training relating to the energy and climate transition, within generalist or specialist teaching tracks in economics, management and finance.

The reasons for training in ethics

At present, training ethics is limited to a minimum: in France, students who prepare for entrance exams into *grandes écoles* in literature and business do indeed study some philosophy. However, this discipline is not taught subsequently, other than in exceptional cases (courses in 'philosophy and commerce' or 'business ethics' are usually optional and are only chosen by a small minority of students). Most other training courses, high-level technical training for engineers or education in universities do not include philosophy classes.

So what are the reasons for teaching ethics and politics? The behaviour described above in relation to recent scandals indicates that a rift separates the world of finance from the rest of society. At the same time, irresponsible

individual behaviour is predominant, with insufficient control and little regard by professional practices for social questions in general. It is therefore important to promote the acquisition of a culture that allows the overall effects of the present form of capitalism to be analysed, that permits moral consideration, both individually and collectively, and that may then help shape criteria for action.

How should this training in ethics be undertaken? It could be argued that in response to the proposal of teaching moral and political philosophy systematically via courses, there is still the danger of formatting students according to the dominant libertarian view of the world. It is precisely this that makes it important to move beyond simply promoting codes of conduct relative to a particular discipline or professional activity, even if such an approach is important. The whole point of drawing on a philosophical approach is precisely to train students in the ability to reason critically, to recognise the presuppositions of any point of view, and to stand back and analyse any form of 'turnkey' evidence or argument – the *doxa*. The aim is to promote students' freedom of thought and judgement, and to favour free and balanced intellectual choices. It is possible to put forward deeper study of the main thinkers in moral philosophy, including both classical (e.g. Plato, Aristotle, Aquinas, Kant) and contemporary thinkers (e.g. Weil, Ricoeur, Walzer,[5] Nussbaum[6]), along with philosophy that takes into consideration relations between human beings and the cosmos, as well as the consequences of human actions on ecosystems (e.g. John Baird Callicott, Hans Jonas, Simon Caney, Henry Shue). All of these ideas should be discussed specifically, as should the means of integrating the concerns of future generations into the policy-making process.[7] This list is obviously not exhaustive. Work by sociologists that looks at companies and the evolution of liberal societies could also be beneficial.[8] The idea is specifically not to give answers or put forward a single line of analysis, but to recognise that ethics can, and undoubtedly should, express itself in all human activity.[9] From this point of view, references to spiritual sources and different religious traditions are especially precious in supporting the ethical dimension of economic and financial activity. For example, the social thinking of the Catholic Church could lead to research into justice and the common good as the criteria for founding any entrepreneurial project.[10] For its part, Islamic banking provides material for examining criteria of justice relating to finance.

Is business ethics sufficient? We have seen how business ethics as taught in management programmes is limited in scope and is instrumental. To be sure, efforts to take into account different 'stakeholders' within a company, in order to offset the power granted to 'shareholders' (according to the economic theory of agency), does allow steps to be taken towards a form of economic activity that respects the just distribution of value added.[11] Similarly, recent calls by apologists of liberal management – such as Professor Michael Porter of Harvard Business School – for 'shared value' are significant in terms of the shift to more cooperative forms of governance and the distribution of profits.[12] However, it is important to go further, in order to look at the distribution of value throughout the production chain – value that is defined in economic, social, and environmental terms.

For these reasons, any analysis of ethics needs to be applied at a macro level and also at a micro, company level. It is important to look at the political weight of economic actors, and especially tax and accounting issues linked to the presence of multinationals in various legal environments (tax havens and other favourable areas). It is also important to set out ethical issues in all specialised curricula: for example, in the teaching of communication, advertising, negotiation and strategy as well as in training in finance, marketing, human resource management and management control. From this point of view the development of social entrepreneurship curricula and 'alternative management' teaching in business schools is a good thing. The aim here is to make such teaching available to all. It would be possible to have 'company role-plays', which are often provided to each new group of students in business schools as learning tools, that seek to identify other rationales for business than the dominant finance one.[13]

In engineering and advanced technical schools, the acquisition of theoretical tools for ethical considerations will directly affect both scientific and technical innovation as well as the economic and financial dimension of companies' activities and their methods of management. These tools should be a priority. To accelerate the shift to a sustainable economy, it is also appropriate to favour generalist training as much as technical training with regard to the energy transition and climate change.

Theoretical consideration is vital, but it is improbable that it is enough to lead to clear awareness by students. If it is not accompanied by the integration of beliefs and values, how will it possibly lead to creating a desire to direct work and professional activity towards an economy that is embedded in society and in the cosmos, which are both clearly seen as meaningful? Students should be given experiences of situations that will help them view reality through different glasses and with different references from those they are used to. For this reason it is suggested here that students should undertake blue-collar training and immersion training in a developing country.

Finally, along with providing initial training to students in ethics and politics, the same interest should be shown in continuing education. Organisations and professional clubs already exist in which the extra-financial dimensions of business are stressed. Religious associations for managers could also be mentioned. Again, the question is how these places of analysis and discussion can contribute to debate in the public arena, thus favouring the formulation of standards and policies covering finance and the economy as a whole. In France, the Grenelle 2 Accords on the Environment marked the beginnings, albeit insufficient, of such an approach. At a global level, the Sustainable Development Goals (SDG), adopted in September 2015, express the willingness of the states to tackle development issues, together with the private sector and civil society. SDG 17 highlights the importance of redirecting private and public resources in order to promote long-term investments, particularly in developing countries.

As expressed by Pope Francis, the current economic and ecological crisis is first ethical and spiritual. Will we succeed in mobilising these ethical resources to promote an inclusive economy?

Notes

1. David Vogel, *The Market for Virtue: The Potential and Limits of Corporate Social Responsibility*, Washington, DC: Brookings Institution, 2005.

2. Cécile Renouard, *La Responsabilité éthique des multinationales*, Paris: Presses Universitaires de France, 2007; 'The Private Sector and the Fight Against Poverty', *Field Actions Science Reports*, Special Issue 4, 2012, http://factsreports.revues.org/1573.

3. Erik Simanis, 'Reality Check at the Bottom of the Pyramid', *Harvard Business Review*, June 2012.

4. Cécile Renouard, *Éthique et Entreprise*, Ivry-sur-Seine: Editions de l'Atelier, 2015.

5. Michaël Walzer, *Spheres of Justice: A Defense of Pluralism and Equality*, New York: Basic Books, 1983; *Thick and Thin: Moral Argument at Home and Abroad*, Notre Dame, IN: University of Notre Dame Press, 1994.

6. Martha C. Nussbaum, *Women and Human Development: The Capabilities Approach*, Cambridge and New York: Cambridge University Press, 2000. This American philosopher has formulated the capabilities approach in connection with Amartya Sen and social science researchers. This is a criticism of development focused on GDP growth. It is based on a holistic and pluralist conception of human development and insists on the political conditions of such development.

7. See in particular the work of Dominique Bourg and Kerry Whiteside.

8. For example, Luc Boltanski and Eve Chiapello, *The New Spirit of Capitalism*, London and New York: Verso, 2005.

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10. Benedict XVI, *Caritas in Veritate*, 2009, http://w2.vatican.va/content/benedict-xvi/en/encyclicals/documents/hf_ben-xvi_enc_20090629_caritas-in-veritate.html; Pope Francis, *Laudato si'*, 2015, http://w2.vatican.va/content/francesco/en/encyclicals/documents/papa-francesco_20150524_enciclica-laudato-si.html.

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13. For example, Cécile Renouard, Pierre-Louis Corteel, Grégory Flipo and Ludovic Rouvier, 'Grameen Danone in Bangladesh: Building, Rebuilding and Sustaining the Social Business', *ESSEC Business Case*, ESSEC Business School Publishing, April 2011.