Profit and the public good

Companies that merely compete and prosper make society better off

Adam Smith, you might say, wrote the book on corporate social responsibility. It is entitled, “Wealth of Nations”.

Every individual necessarily labours to render the annual revenue of the society as great as he can. He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it. He intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention. Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good.

It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages.

Smith did not worship selfishness. He regarded benevolence as admirable, as a great virtue, and he saw the instinct for sympathy towards one’s fellow man as the foundation on which civilised conduct is built. He wrote another book about this: “The Theory of Moral Sentiments”. But his greatest economic insight—and indeed the greatest single insight yielded by the discipline of economics—was that benevolence was not in fact necessary to advance the public interest, so long as people were free to engage with each other in voluntary economic interaction. That is fortunate, he pointed out, since benevolence is often in short supply. Self-interest, on the other hand, is not.

If self-interest, guided as though by an invisible hand, inadvertently serves the public good, then it is easy to see why society can prosper even if people are not always driven by benevolence. It is because Smith was right about self-interest and the public interest that communism failed and capitalism worked.

Most advocates of CSR, especially those run by giant international corporations, have probably read some economics in their time. Many of the officials at the United Nations, World Bank and OECD who argue in favour of CSR have advanced degrees in the subject from the best universities. Yet they have apparently failed to grasp this most basic and necessary insight of the entire discipline. Through the action of Smith’s invisible hand, the private search for profit does advance the public interest. There is no need for thought-leaders in CSR armed with initiatives and compacts to bring this about.

Smith was a genius because this harmony of private interest and public interest is not at all obvious—and yet, at the same time, once pointed out, the idea is instantly simple and plausible. This is especially so if you think not about self-interested individuals but about profit-seeking companies. The value that people attach to the goods and services they buy from companies is shown by what they are willing to pay for them. The costs of producing those goods and services are a measure of what society has to surrender to consume those things. If what people pay exceeds the cost, society has gained—and the company has turned a profit. The bigger the gain for society, the bigger the profit. So profits are a guide (by no means a perfect one, but a guide nonetheless) to the value that companies create for society.

Does this mean that Gordon Gekko, the odious protagonist of the movie, “Wall Street”, was right to say that “greed is good”? No: greed and self-interest are not the same thing, as Mr Gekko discovered in that movie. Greed, in the ordinary meaning of the word, is not rational or calculating. Freely indulged, it makes you fat and drives you into bankruptcy. The kind of self-interest that advances the public good is rational and enlightened. Rational, calculating self-interest makes a person, or a firm, worry about its reputation for honesty and fair dealing, for paying debts and honouring agreements. It looks beyond the short term and plans ahead. It considers sacrifices today for the sake of gains tomorrow, or five years from now. It makes good neighbours.

Morally, also, there is a world of difference between greed and self-interest. The first, even if it were not self-defeating, would still be a gross perversion of the second. Failing to see this distinction, and thus concluding without further thought that private enterprise is tainted, is a kind of ethical stupidity. Greed is ugly. There is nothing ignoble, in contrast, about a calm and moderate desire to advance one’s own welfare, married (as it is in most people) to a sympathetic regard for the well-being of others. And, as Smith pointed out, rational self-interest also happens to make the world go round.

Faulty premise

The premise thatCSR advocates never question is in fact wrong. It is an error to suppose that profit-seeking, as such, fails to advance the public good, and that special efforts to give something back to society are needed to redeem it.

However, as already noted, profit succeeds as an indicator of value creation, and as a signal that draws new investment to socially useful purposes, only under cer-
tain circumstances. It cannot be taken for
granted that these conditions will always
be satisfied.

One main requirement is that firms are
in competition with each other. The profits
that a monopoly can extract from the econ-
omy are a measure of market power, not
social gain. And monopoly profits may not
serve as an effective signal for new invest-
ment if economic barriers of one kind or
another hamper competition by keeping
new entrants off the monopolist’s turf.

Oddly enough, business leaders who
voice their commitment to good corporate
citizenship rarely demand the removal of
barriers to competition in their industries—a measure that would almost invari-
ably serve the public interest. Manufac-
turers are far more likely to call for import
barriers to be raised against their foreign
competitors than they are to call for exist-
ing tariffs or other barriers to come down.
Producers of all manner of goods and ser-
vices are more likely to call for the intro-
duction of licences and controls to protect
their existing positions in their markets
than to demand that newcomers should
be permitted and even encouraged to con-
test those markets.

And CSR often helps them in this. Al-
though it is true that many business lead-
ers mean what they say about good cor-
porate citizenship, and speak up for CSR
in good faith, CSR is nonetheless far more of-
ten invoked as a rationale for anti-competi-
tive practices than as a reason to bolster
competition. Incumbent firms or profes-
sions seem to find it easier to comply with
burdensome regulations if they know that
those rules are deterring new entrants.
That is why, often in the name of CSR, in-
cumbent businesses are so given to calling
for rules and standards to be harmonised
and extended, both at home and abroad.

For the good of the public, you under-
stand, barristers are opposed to reforms
that would allow solicitors to appear more
often as advocates in English courts (their
training just isn’t up to it). For the safety of
the consumer, American pharmaceutical
companies insist, extraordinary precau-
tions must be taken before drugs can be
imported from Canada (even knows what
the Canadians, a devil-may-care sort of
people, put into those pills). For the good
of the world’s poor, industrial-country
manufacturers believe, goods should not
be imported from countries where em-
ployees have to work long hours for low
pay and without statutory vacations (that
is unfair trade).

A great deal of economic regulation
makes sense for one reason or another. But
it is striking that business leaders—espe-
cially, it seems, those who speak up most
enthusiastically for CSR—call for regula-
tion that restricts competition far more of-
ten than they call for regulation that
strengthens it. This prompts the thought
that the design of economic regulation is
best left to governments, rather than to cor-
porate citizens, however enlightened.

Social prices
A second condition must be met before
one can be sure that private enterprise in
competitive markets is advancing the pub-
lic good. Prices need to reflect true social
costs and benefits. Many transactions,
however, have side-effects—externalities,
as they are called. Where they do, private
costs and benefits diverge from public
costs and benefits. Sometimes external-
ities are positive. If your neighbour rep-
paints his house, that may increase the
value of yours; since he fails to capture all
the gains created by his spending, he may
repaint his house less frequently than
would be best for society at large—or, in
this case, for your end of the street. Markets
tend to undersupply goods that involve
positive externalities.

Externalities can also be negative. The
classic instance is a polluting factory. The
owners of the factory and the customers
for its goods do not have to bear the full
costs of the pollution that comes out of its
smokestacks. Failing to take that into ac-
count, the market sets the price of the fac-
tory’s goods too low. Demand for the pro-
duct is stronger than it should be. Goods
that involve negative externalities tend to
be oversupplied.

This kind of argument is invoked
make sense of “sustainable develop-
to the claims pressed on business by
ment” and the idea that prices are wrong, the argument goes
so markets are failing. Pollution, include:
the accumulation of greenhouse gases
not priced into the market, so there is
much of it. Impeding shortages of nat-
ural resources are not priced into the market
those resources are consumed too rap-
idsy. The value of wilderness, either for
beauty or for its stocks of endangered
species, is not priced into the market, so
much of it gets cemented over.

Whether the pattern of consumption
based on these false prices is sustain-
ability. Some pattern of consumption could be indefinitely
Maintained but still be wrong, causing mo-
damage as far ahead as one can
Others might indeed be unsustainable
meaning bound to be halted at a point, yet not be wrong, as when
the proaching exhaustion of a raw mat-
tial leads to the invention of a substitute. “S
ainability” has a nice ring to it, but it is the issue. The question is whether
prices are causing big economic mista-
and, if so, what might be done about it
Many market prices do diverge from
the corresponding “shadow prices”
would direct resources to their sus-
best uses. In many cases, the diverges
big enough to warrant governmen-
tal action—a point which all governments
usually on board, sometimes to a fault
industrial-country governments inter-
their economies. In principle, this
intervention aims to mitigate the
allocation of resources caused by externalities and other kinds of market failure. But it is important to keep a sense of proportion about the supposed unlikelihood of market signals.

So far as environmental externalities are concerned, most leading advocates of CSR seem to be in the grip of a grossly exaggerated environmental pessimism. The claim that economic growth is necessarily bad for the environment is an article of faith in the CSR movement. But this idea is simply wrong.

Natural resources are not running out, if you measure effective supply in relation to demand. The reason is that scarcity raises prices, which spurs innovation: new sources are found, the efficiency of extraction goes up, existing supplies are used more economically, and substitutes are invented. In 1970, global reserves of copper were estimated at 280m tonnes; during the next 30 years about 270m tonnes were consumed. Where did estimated reserves of copper stand at the turn of the century? Not at 100m tonnes, but at 340m. Available supplies have surged, and, it so happens, demand per unit of economic activity has been falling: copper is being replaced in many of its main industrial applications by other materials (notably, fibre-optic cable instead of copper wire for telecommunications).

Copper, therefore, is unlikely ever to run out—and if it did, in some very distant future, it would be unlikely by then to matter. The same is true for other key minerals. Reserves of bauxite in 1970 were 5.3 billion tonnes; the amount consumed between 1970 and 2000 was around 3 billion tonnes; reserves by the end of the century stood at 25 billion tonnes. Or take energy. Oil reserves in 1970: 580 billion barrels. Oil consumed between 1970 and the turn of the century: 690 billion barrels. Oil reserves in 2000: 1,050 billion barrels. And so on.

The colour of gloom
What about pollution? On the whole, rich countries are less polluted than poor countries, not more. The reason is that wealth increases both the demand for a healthier environment and the means to bring it about. Environmental regulation has been necessary to achieve this, to be sure, because pollution is indeed an externality. But it is not true that the problem has been left unattended in the rich world, that things are therefore getting worse, and that CSR initiatives have to rise to the challenge of dealing with this neglect.

Strong environmental protection is already in place in Europe and the United States. In some cases, no doubt, it needs to be strengthened further. In some other cases, most likely, it is already too strong. Overall, the evidence fails to show systematic neglect, or any tendency, once government regulation is taken into account, for economic growth to make things worse.

How much of an exception to this is global warming? Potentially, as many CSR advocates say, a very important one. Emissions of greenhouse gases are causing stocks of carbon in the atmosphere to grow rapidly. Almost all climate scientists expect this to raise temperatures to some unknown extent during the coming decades. If temperatures rise towards the upper end of current projections, the environmental damage will be great.

Yet the world still lacks an effective regime for global carbon abatement. This is not too much because the United States has refused to support the Kyoto agreement as because that agreement is deeply flawed in any case—but this is beside the point. Global warming is a potentially very significant externality that governments up to now have failed to address properly.

Another such case is excessive encroachment on wilderness areas. Once a wilderness has been lost, it cannot be replaced—and, unlike for copper or oil, there will never be a substitute. Governments in many rich and poor countries are neglecting this issue.

But on questions such as these, where governments are, it seems, leaving significant market failures unaddressed, the question for businesses is whether CSR can do anything useful to bridge the gap. Many companies at the forefront of the CSR movement have embarked on initiatives of their own, aimed, for example, at reducing greenhouse-gas emissions or at protecting wilderness areas.

These would need to be judged case by case, to see whether particular policies were instances of "good management" (as when an oil company invests profitably in alternative fuels, anticipating both shifts in consumer demand and forthcoming taxes on carbon), "borrowed virtue", (for example, creating private wilderness reserves at shareholders' expense), "pernicious CSR" (blocking competition in the name of spurious environmental goals) or "delusional CSR" (increasing emissions of greenhouse gases in order to conserve raw materials that are not in diminishing supply).

There will be good and bad. As a general rule, however, correcting market failures is best left to government. Businesses cannot be trusted to get it right, partly because they lack the wherewithal to frame intelligent policy in these areas. Aside from the implausibility of expecting the uncoordinated actions of thousands of private firms to yield a coherent optimising policy on global warming, say, there is also what you might call the constitutional issue. The right policy on global warming is not clear-cut even at the global level, to say nothing of the national level or the level of the individual firm or consumer. Devising such a policy, and sharing the costs equitably, is a political challenge of the first order. Setting such questions exceeds both the competence and the proper remit of private enterprise.