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What's a Business For?

by **Charles Handy**

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Could capitalists actually bring down capitalism? A writer for the *New York Times* asked that question earlier this year, as the accounting scandals involving big U.S. companies piled up. No, he concluded, probably not. A few rotten apples would not contaminate the whole orchard, the markets would eventually sort the good from the bad, and, in due time, the world would go on much as before.

Not everyone is so complacent. Markets rely on rules and laws, but those rules and laws in turn depend on truth and trust. Conceal truth or erode trust, and the game becomes so unreliable that no one will want to play. The markets will empty and share prices will collapse, as ordinary people find other places to put their money—into their houses, maybe, or under their beds. The great virtue of capitalism—that it provides a way for the savings of society to be used for the creation of wealth—will have been eroded. So we will be left to rely increasingly on governments for the creation of our wealth, something that they have always been conspicuously bad at doing.

Such extreme scenarios might have seemed laughable a few years ago, when the triumph of American-style capitalism appeared self-evident, but no one should be laughing now. In the recent scandals, truth seemed too easily sacrificed to expediency and to the need, as the companies saw it, to reassure the markets that profits were on target. John May, a stock analyst for a U.S. investor service, pointed out that the pro forma earnings announcements by the top 100 NASDAQ companies in the first nine months of 2001 overstated actual audited profits by $100 billion. Even the audited accounts, it now seems, often made things appear better than they really were.

Trust, too, is fragile. Like a piece of china, once cracked it is never quite the same. And people's trust in business, and those who lead it, is today cracking. To many, it seems that executives no longer run their companies for the benefit of consumers, or even of their shareholders and employees, but for their personal ambition and financial gain. A Gallup poll conducted early this year found that 90% of Americans felt that people running corporations could not be trusted to look after the interests of their employees, and only 18% thought that corporations looked after their shareholders a great deal. Forty-three percent, in fact, believed that senior executives were only in it for themselves. In Britain, that figure, according to another poll, was 95%.

What has gone wrong? It is tempting to blame the people at the top. Keynes once wrote, "Capitalism is the astounding belief that the most wickedest of men will do the most wickedest of things for the greatest good of everyone." Keynes was exaggerating. Personal greed, insufficient scrutiny of corporate affairs, an insensitivity or an indifference to public opinion: Those charges could be leveled against some business leaders, but few, thankfully, have been guilty of deliberate fraud or wickedness. All they've been doing is playing the game according to the new rules.

In the current Anglo-American version of stock market capitalism, the criterion of success is shareholder value, as expressed by a company's share price. There are many ways of influencing share price, of which increasing productivity and long-term profitability is only one. Cutting or postponing expenditures that are geared to the future rather than the present will increase profits immediately even if it imperils them over the long term. Buying and selling businesses is another favored strategy. It is a far quicker way to boost your balance sheet and share price than relying on organic growth and, for those at the top, can be much more interesting. The fact that most mergers and acquisitions do not, in the end, add value has not discouraged many executives from trying.

One result of the obsession with share price is an inevitable shortening of horizons. Paul Kennedy is not alone in believing that companies are mortgaging their futures in return for a higher stock price in the present, but he may be optimistic in sensing the end of the obsession with shareholder value.

The stock option, that new favorite child of stock market capitalism, must also shoulder a large part of the blame. Whereas in 1980 only about 2% of executive pay in the United States was tied to stock options, it is now thought to be more than 60%. Executives, not unnaturally, want to realize their options as soon as they can, rather than relying on the actions of their successors. The stock option has also acquired a new popularity in Europe, as more and more companies go public. To many Europeans, however, hugely undervalued stock options seem like just another way of allowing executives to steal from their companies and their shareholders.

Europeans raise their eyebrows, sometimes in jealousy but more often in outrage, at the levels of executive remuneration under stock market capitalism. Reports that CEOs in America earn more than 400 times the wages of their lowest-paid workers make a mockery of Plato's ideal, in what was, admittedly, a smaller and simpler world, that no person should be worth more than four times another. Why, some wonder, should business executives be rewarded so much better financially than those who serve society in all the other professions? The suspicion, right or wrong, that business takes care of itself before it cares for others only fuels the latent distrust.

Europeans continue to look at America with a mix of envy and trepidation. They admire the dynamism, the entrepreneurial energy, and the insistence on everyone's right to chart his or her own life. But they worry now, as they watch their own stock markets follow Wall Street downhill, that the flaws in the American model of capitalism are contagious.

The American disease is not just a matter of dubious personal ethics or of some rogue companies fudging the odd billion. The country's whole business culture may have become distorted. This was the culture that enraptured America for a generation, a culture underpinned by a doctrine that proclaimed the market king, always gave priority to the shareholder, and believed that business was the key engine of progress and thus should take precedence in policy decisions. It was a heady doctrine that simplified life with its dogma of the bottom line, and during the Thatcher years it infected Britain. It certainly revived the entrepreneurial spirit in that country, but it also contributed to a decline in civic society and to an erosion of the attention and money paid to the nonbusiness sectors of health, education, and transport—a neglect whose effects haunt the current British government.

Continental Europe was always less enthralled by the American model. Stock market capitalism had no place for many of the things that Europeans take for granted as the benefits of citizenship—free health care and quality education for all, housing for the disadvantaged, and a guarantee of reasonable living standards in old age, sickness, or unemployment. Nevertheless, the accusations from across the Atlantic of a lack of dynamism in Europe, of sclerotic economies bogged down in regulations, and of lackluster management began to hurt, and even on the Continent the American way of business started to take hold. Now, after a series of Europe's own examples of skulduggery at the top and a couple of high-profile corporate collapses due to overambitious acquisition policies, many on the Continent wonder if they've drifted too far toward stock market capitalism.

We can now see, with hindsight, that in the boom years of the 1990s America had often been creating value where none existed, bidding up the market capitalizations of companies to 64 times earnings, or more. And that's far from the country's only problem. The level of indebtedness of U.S. consumers may well be unsustainable, along with the country's debts to foreigners. Add to this the erosion of confidence in the balance sheets and boards of directors of some of the largest U.S. corporations, and the whole system of channeling the savings of citizens into fruitful investments begins to look questionable. That is the contagion that Europe fears.

Capitalist fundamentalism may have lost its sheen, but the urgent need now is to retain the energy produced by the old model while remedying its flaws. Better and tougher regulation would help, as would a clearer separation of auditing from consulting. Corporate governance will now surely be taken more seriously by all concerned, with responsibilities more clearly defined, penalties spelled out, and watchdogs appointed. But these will be plasters on an open sore. They will not cure the disease that lies at the core of the business culture.

We cannot escape the fundamental question, Whom and what is a business for? The answer once seemed clear, but no longer. The terms of business have changed. Ownership has been replaced by investment, and a company's assets are increasingly found in its people, not in its buildings and machinery. In light of this transformation, we need to rethink our assumptions about the purpose of business. And as we do so, we need to ask whether there are things that American business can learn from Europe, just as there have been valuable lessons that the Europeans have absorbed from the dynamism of the Americans.

Both sides of the Atlantic would agree that there is, first, a clear and important need to meet the expectations of a company's theoretical owners: the shareholders. It would, however, be more accurate to call most of them investors, perhaps even gamblers. They have none of the pride or responsibility of ownership and are, if truth be told, only there for the money. Nevertheless, if management fails to meet their financial hopes, the share price will fall, exposing the company to unwanted predators and making it more difficult to raise new finance. But to turn shareholders' needs into a purpose is to be guilty of a logical confusion, to mistake a necessary condition for a sufficient one. We need to eat to live; food is a necessary condition of life. But if we lived mainly to eat, making food a sufficient or sole purpose of life, we would become gross. The purpose of a business, in other words, is not to make a profit, full stop. It is to make a profit so that the business can do something more or better. That "something" becomes the real justification for the business. Owners know this. Investors needn't care.

To many this will sound like quibbling with words. Not so. It is a moral issue. To mistake the means for the end is to be turned in on oneself, which Saint Augustine called one of the greatest sins. Deep down, the suspicions about capitalism are rooted in a feeling that its instruments, the corporations, are immoral in that they have no purpose other than themselves. To make this assumption may be to do many companies a great injustice, but they have let themselves down through their own rhetoric and behavior. It is salutary to ask about any organization, "If it did not exist, would we invent it?" "Only if it could do something better or more useful than anyone else" would have to be the answer, and profit would be the means to that larger end.

The idea that those who provide the finance are a company's rightful owners, rather than just its financiers, dates from the early days of business, when the financier was genuinely the owner and usually the chief executive as well. A second and related hangover from earlier times is the idea that a company is a piece of property, subject to the laws of property and ownership. This was true two centuries ago, when corporate law originated and a company consisted of a set of physical assets. Now that the value of a company resides largely in its intellectual property, in its brands and patents and in the skills and experience of its workforce, it seems unreal to treat these things as the property of financiers, to be disposed of as they wish. This may still be the law, but it hardly seems like justice. Surely, those who carry this intellectual property within them, who contribute their time and talents rather than their money, should have some rights, some say in the future of what they also think of as "their" company?

It gets worse. The employees of a company are treated, by the law and the accounts, as the property of the owners and are recorded as costs, not assets. This is demeaning, at the very least. Costs are things to be minimized, assets things to be cherished and grown. The language and the measures of business need to be reversed. A good business is a community with a purpose, and a community is not something to be "owned." A community has members, and those members have certain rights, including the right to vote or express their views on major issues. It is ironic that those countries that boast most stridently about their democratic principles derive their wealth from institutions that are defiantly undemocratic, in which all serious power is held by outsiders and power inside is wielded by a dictatorship or, at best, an oligarchy.

Corporate law in both America and Britain is out of date. It no longer fits the reality of business in the knowledge economy. Perhaps it didn't even fit business in the industrial era. In 1944 Lord Eustace Percy, in Britain, said this: "Here is the most urgent challenge to political invention ever offered to statesman or jurist. The human association which in fact produces and distributes wealth, the association of workmen, managers, technicians, and directors, is not an association recognized by law. The association which the law does recognize—the association of shareholders, creditors and directors—is incapable of production or distribution and is not expected by the law to perform these functions. We have to give law to the real association and to withdraw meaningless privileges from the imaginary one." Almost 60 years later, the European management writer Arie de Geus argued that companies die because their managers focus on the economic activity of producing goods and services and forget that their organization's true nature is that of a community of people. Nothing, it seems, has changed.

The countries of mainland Europe, however, have always regarded the corporation as a community whose members have legal rights, including, in Germany for instance, the right of the employees to have half, minus one, of the seats on the supervisory board as well as numerous safeguards against dismissal without due cause and an array of statutory benefits. These rights certainly limit the flexibility of management, but they help cultivate a sense of community, generating the feeling of security that makes innovation and experimentation possible and the loyalty and commitment that can see a company through bad times. Shareholders are seen as trustees of the wealth inherited from the past. Their duty is to preserve and, if possible, increase that wealth so that it can be passed on to future generations.

Such an approach is easier for companies on the Continent. Their more closed systems of ownership and greater reliance on long-term bank finance shield them from predators and short-term profit pressures. In most cases, a company's equity capital is concentrated in the hands of other companies, banks, or family networks, with private shareholders owning only a small percentage. Pension funds, too, are neither as large nor as powerful as they are in America and Britain, mainly because European companies keep pensions under their own control, using the funds as working capital. Ownership and governance structures differ from country to country, but in general it can be said that the cult of equity is not as prominent in mainland Europe. As a result, hostile takeovers are difficult and rare, and companies can pay greater heed to the long term and to the needs of constituents other than shareholders.

Countries are shaped by their histories. The Anglo-Saxon nations could not adopt any of the European models even if they wished to. Both cultures, however, need to restore confidence in the wealth-creating possibilities of capitalism and in its instruments, the corporations. In both cultures some things need to change. More honesty and reality in the reporting of results would help, for a start. But when so many of a company's assets are now invisible, and therefore uncountable, and when the webs of alliances, joint ventures, and subcontracting partnerships are so complex, it will never be possible to present a simple financial picture of a major business or to find one number that sums it all up. America's new requirement that chief executives and chief financial officers attest to the truth of their companies' financial statements may concentrate their minds wonderfully, but they can hardly be expected to double-check the work of their accountants and auditors.

If, however, this new requirement pushes accountability for truth telling down the line, some good may result. If a company takes seriously the idea of itself as a wealth-creating community, with members rather than employees, then it will only be sensible for members to validate the results of their work before presenting them to the financiers, who might, in turn, have greater trust in the accuracy of those statements. And if the cult of the stock option wanes with the decline of the stock market and companies decide to reward their key people with a share of the profits instead, then those members will be even more likely to take a keen interest in the truth of the numbers. It seems only fair that dividends be paid to those who contribute their skills as well as to those who have contributed their money. Most of the latter, after all, have not in fact paid any money to the company itself but only to the shares' previous owners.

It may be only a matter of time before such changes come to pass. Already, people whose personal assets are highly valued—bankers, brokers, film actors, sports stars, and the like—make a share of profits, or a bonus, a condition of their employment. Others, such as authors, get all their remuneration from a share of the income stream. This form of performance-related pay, in which the contribution of a single member or group can be identified, seems bound to grow along with the bargaining power of key talent. We should not ignore the examples of organizations, such as sports teams and publishing houses, whose success has always been tied to the talents of individuals and who, over the years or even the centuries, have had to work out how best to share both the risks and the rewards of innovative work. In the growing world of talent businesses, employees will be increasingly unwilling to sell the fruits of their intellectual assets for an annual salary.

A few small European corporations already distribute a fixed proportion of after-tax profits to the workforce, and these payments become a very tangible expression of members' rights. As the practice spreads, it will make sense to discuss strategies and plans in broad outline with representatives of the members so that they can share in the responsibility for their future earnings. Democracy, of sorts, will have crept in through the pay packet, bringing with it, one hopes, more understanding, more commitment, and more contribution.

Such changes in compensation may help remedy capitalism's democracy deficit, but they won't repair the image of business in the wider community. They might, in fact, be seen as spreading the cult of selfishness a little wider. Two more things need to happen to cure capitalism's current disease—and there are signs that these changes are already under way.

The ancient Hippocratic oath that many doctors swear on graduation includes an injunction to do no harm. Today's anti-globalization protesters claim that global businesses not only do harm, but that the harm outweighs the good. If those charges are to be rebutted, and if business is to restore its reputation as the friend, not the enemy, of progress around the world, then the leaders of those companies need to bind themselves with an equivalent oath. Doing no harm goes beyond meeting the legal requirements regarding the environment, conditions of employment, community relations, and ethics. The law always lags behind best practice. Business needs to take the lead in areas such as environmental and social sustainability instead of forever letting itself be pushed onto the defensive.

John Browne, CEO of BP, the oil giant, is one person who is prepared to do some of the necessary advocacy. In a public lecture broadcast on BBC radio in 2000, he said that the business community is not in opposition to sustainable development but is in fact essential to delivering sustainability, because only business can produce the technological innovations and deliver the means for genuine progress on this front. And business needs a sustainable planet for its own survival, for few companies are short-term entities; they want to do business again and again, over decades. Many other business leaders now agree with Browne, and they are beginning to shape their actions to fit their words. Some are even finding that there is money to be made from creating the products and services that sustainability requires.

Unfortunately, the majority of companies still see such concepts as sustainability and social responsibility as pursuits that only the rich can afford. For them, the business of business is business and should remain so. If society wants to put more constraints on the way business operates, they argue, it can pass more laws and enforce more regulations. Such a minimalist and legalistic approach leaves business looking like the potential despoiler who must be reined in. And given the legal time lag, the reins may always seem too loose.

In the knowledge economy, sustainability must extend to the human as well as the environmental level. Many people have seen their ability to balance work with the rest of their lives deteriorate steadily, as they fall victim to the stresses of the long-hours culture. An executive life, some worry, is becoming unsustainable in social terms. We are in danger of populating companies with the modern equivalent of monks, who forgo all else for the sake of their calling. If the contemporary business, with its foundation of human assets, is to survive, it will have to find better ways to protect people from the demands of the jobs it gives them. Neglecting the environment may drive away customers, but neglecting people's lives may drive away key members of the workforce. Here, again, it would help for companies to see themselves as communities whose members have individual needs as well as individual skills and talents. They are not anonymous human resources.

The European example—with its five to seven-week annual holidays, legally mandated parental leaves for fathers and mothers together, growing use of sabbaticals for senior executives, and working weeks of fewer than 40 hours—helps promote the idea that long work is not necessarily good work, and that the organization serves its own interests when it protects the overzealous from themselves. Many French companies were surprised that productivity increased when their last government required them to restrict the working week to 35 hours on average (a requirement being repealed by the current government). Europe's approach is one manifestation of the concept of the organization as community. The growing practice of customizing workers' contracts and development plans is another.

More corporate democracy and better corporate behavior will go a long way to improve the current business culture in the eyes of the public, but unless these changes are accompanied by a new vision of the purpose of business, they will be seen as mere palliatives. It is time to raise our sights above the purely pragmatic. Article 14, section 2 of the German constitution states, “Property imposes duties. Its use should also serve the public weal.” There is no such clause in the United States Constitution, but the sentiment is echoed in some companies’ philosophies. Dave Packard once said, “I think many people assume, wrongly, that a company exists simply to make money. While this is an important result of a company’s existence, we have to go deeper and find the real reasons for our being. As we investigate this, we inevitably come to the conclusion that a group of people get together and exist as an institution that we call a company so that they are able to accomplish something collectively that they could not accomplish separately—they make a contribution to society, a phrase which sounds trite but is fundamental.”

The contribution ethic has always been a strong motivating force. To survive, even to prosper, is not enough. We hanker to leave a footprint in the sands of time, and if we can do that with the help and companionship of others, so much the better. We need to associate with a cause in order to give purpose to our lives. The pursuit of a cause does not have to be the prerogative of charities and the not-for-profit sector. Nor does a mission to improve the world make business into a social agency.

By creating new products, spreading technology and raising productivity, enhancing quality and improving service, business has always been the active agent of progress. It helps make the good things of life available and affordable to ever more people. This process is driven by competition and spurred on by the need to provide adequate returns to those who risk their money and their careers, but it is, in itself, a noble cause. We should make more of it. We should, as charitable organizations do, measure success in terms of outcomes for others as well as for ourselves.

George W. Merck, the son of the pharmaceutical company’s founder, always insisted that medicine was for the patients, not for the profits. In 1987,in keeping with this core value, his successors decided to give away a drug called Mectizan, which cures river blindness, an affliction in a number of developing countries. The shareholders were probably not consulted, but had they been, many would have been proud to be associated with such a gesture.

Business cannot always afford to be so generous to so many people, but doing good does not necessarily rule out making a reasonable profit. You can, for example, make money by serving the poor as well as the rich. As C.K. Prahalad and Allen Hammond recently pointed out in this magazine, there is a huge neglected market in the billions of poor in the developing world. Companies like Unilever and Citicorp are beginning to adapt their technologies to enter this market. Unilever can now deliver ice cream in India for just two cents a portion because it has rethought the technology of refrigeration. Citicorp can now provide financial services to people, also in India, who have only $25 to invest, again through rethinking technology. In both cases the companies make money, but the driving force is the need to serve neglected consumers. Profit often comes from progress.

There are more such stories of enlightened business in both American and European companies, but they remain the minority. Until and unless they become the norm, capitalism will continue to be seen as the rich man’s game, serving mainly itself and its agents. High-minded talent may start to shun it and customers desert it. Worse, democratic pressures may force governments to shackle corporations, limiting their independence and regulating the smallest details of their operations. And we shall all be the losers.