Just Profit - What is Fair?

Reflections I Mutuality in Business

Colin Mayer February 2015

About the Author

Colin Mayer CBE is the Peter Moores Professor of Management Studies at Saïd Business School, and the former Peter Moores Dean of the School between 2006 and 2011. He is an expert on all aspects of corporate finance, governance and taxation, the regulation of financial institutions and the role of the corporation in contemporary society. He teaches the elective course on Mergers, Acquisitions and Restructurings on the MBA and the Masters in Financial Economics, the core programme on Responsible Business for MBA students, an elective on the Nature of the Corporation for MBA and Masters in Financial Economics students, and the Principles of Financial Regulation on the Masters in Law and Finance.

Colin studied as an undergraduate at Oriel College, Oxford, and received his DPhil from Oxford University in 1981. He was a Harkness Fellow at Harvard University, a Houblon-Norman Fellow at the Bank of England, the first Leo Goldschmidt Visiting Professor of Corporate Governance at the Solvay Business School, Université de Bruxelles, and has had visiting positions at Columbia, MIT and Stanford universities. In 1994, Colin became the first professor at Saïd Business School, and was appointed the Peter Moores Dean of the Business School between 2006 and 2011. He was the first Director of the Oxford Financial Research Centre at the University of Oxford between 1998 and 2005.

Colin has served on the editorial boards of several leading academic journals and assisted in establishing prestigious networks of economics, law and finance academics in Europe at the Centre for Economic Policy Research and the European Corporate Governance Institute. He was a founding editor of the Oxford Review of Economic Policy and a founding co-editor of the Review of Finance.

Colin was a director and chairman of Oxera between 1986 and 2010, and was instrumental in building the firm into what is now one of the largest independent economics consultancies in Europe. He is a director of Aurora Energy Research Limited, an energy modelling company. He has consulted for numerous large corporations and for governments, regulators and international agencies around the world.

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Areas of expertise include:

- Corporate finance
- Corporate governance
- Corporate taxation
- The regulation of financial institutions
- The role of the corporation in contemporary society

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Just Profit – What is Fair?

There are many different notions of profit.

In an economics context it is thought of in regard to the marginal product of capital. John Hicks, for example, defined it in terms of the permanent income stream that can be derived from capital.

In finance, it is considered in regard to the opportunity cost of capital – the rate of return that is required to compensate investors for the return that they could be earning elsewhere and the risk that they are incurring from the investment.

In accounting, it is measured as a residual after the costs of the business including depreciation and the cost of maintenance of its capital have been met.

In sociology, it is thought of in relation to a team contribution where the marginal product of each individual factor of production cannot be identified but where the distribution of the benefits should promote cooperative team production.

In political and moral philosophy, it is considered in relation to what is just and fair from the perspective of society as a whole and what contributes to a harmonious society.

In principle one can attempt to synthesize these different approaches through for example introducing notions of distribution as well as efficiency into economic objectives and concepts of the size of the cake as well as its distribution into ethical viewpoints. In practice, the different viewpoints are a dialogue of the deaf and each literature proceeds with only scant regard for the others.

The argument that will be pursued here is that the absence of a unifying framework reflects the fact that there is not a correct notion of profit and that what is missing from all of the above discussions is a prior notion of purpose. To be able to define what is an appropriate level of profit and distribution of the benefit of a corporation one firstly has to establish its purpose.

To appreciate this it is helpful to start from the accounting and finance perspective. The traditional approach is to measure the amount of financial capital employed by shareholders and to evaluate the profit that accrues to them after the costs of other inputs including capital depreciation have been met. That can then be compared with measures of the expected return as reflected in asset pricing models, which take account of the risk of activities of the firm.

If profit is high in relation to the expected return then the firm is earning an “excessively” high profit which may be indicative of its exceptional skill and ability, i.e. unusually high productivity in the economics context, or monopoly or monopsony exploitation of consumers and suppliers. So a high rate of return in relation to the cost of capital is *prima facie* evidence of abuse that warrants further investigation of whether it is justified.

Another way of thinking about this is that for the investors to be willing to continue to invest in the firm and not sell out and shift their investments elsewhere then they need to earn a return on the capital employed that is at least equal to the cost of capital. So this is the minimum that they can be paid to them without threatening the viability of the firm.

Why this is potentially a misleading approach and the reason why the sociological and political and moral philosophy literatures have taken a different line is that it fails to recognise that there are parties, other than shareholders, who have a stake and investments in the firm. In particular, employees are stakeholders with human capital invested in the firm and society more generally has an interest in the firm in terms of the level and development of social capital.

The counterargument to this assertion of many stakeholders is that other parties have contractual relations with the firm that shareholders do not possess and are protected by these contracts, e.g. employment or supplier contracts and public law in relation to society more generally. However, this is misleading because contracts are at best incomplete in not providing other parties with complete protection, often unenforceable as in the case of the position of creditors in bankrupt financial institutions during the financial crisis, or infeasible in relation to the poorest people in the world or future generations who have no voice let alone contracts.

It is not therefore possible to ignore the capital invested by other parties, in particular the human capital of employees and the social capital of societies and the natural capital of future generations. If these are taken into account then the returns to financial capital have to be measured after not just the capital maintenance of financial capital but also the capital maintenance of human, natural and social capital.

What does that mean? It means that corporate income not only has to maintain the existing stock of physical capital of the firm – its plant, buildings and inventories – but also its human capital – the future earning capability of its employees through education, training, skills development, pension provision etc. – its natural capital – the maintenance and sustainability of any natural capital it destroys or consumes – and its social capital – the fabric of the societies in which it operates, their infrastructure, social provision, levels of social cohesion, trust etc.

In this context the notion of profit retains a residual connotation as being net of the maintenance of capital but where the capital is much more broadly defined to include not just financial but also human, natural and social capital. To give one illustration, the maintenance of human capital may be to assert that at no point in the supply chain should anyone be employed who earns less than a living wage in the communities in which they live. Likewise, as in the Hicksian notion of profit so too the maintenance of human capital may be deemed to extend to the sustainability of a permanent income stream over the life of an employee.

What this implies is that the liability of the corporation is not just to the maintenance of the interests of its financial investors or owners but also to its employees, communities and relevant future generations. As such then it leads to a residual notion of profit that requires the "fair" treatment of other parties in maintaining the value of their capital as well as those of the investors.

However, the concept of fairness can go beyond just sustaining existing conditions. That could be interpreted as meaning just maintaining employees in developing countries in their current impoverished state or working in the appalling factory conditions that they often currently endure. Were they given more voice in the policy of the firm then its objectives would be more ambitious than that and set goals of enhancing not just preserving current conditions, through for example not just paying a living wage but a wage that allows for advancement, savings and investment on their part as well.

What this then points to is that the notion of a fair profit is one that is not only more inclusive of parties beyond financial investors and owners but also dependent on the objectives and the purpose of the firm. A mutual firm that is owned by its employees will have different notions of purpose from that of a widely held listed company. However, the purpose of the firm is one that owners, particularly where ownership is concentrated in the hands of a relatively small number of people, can determine for themselves.

So for example, the relative significance that should be attached to maintaining and enhancing the value of human versus social capital, or natural versus financial capital is not a question to which there is a right answer. It depends on the views and preferences of the parties to the firm and the willingness of the owners to accept an allocation that differs from simply maximising financial benefit.

What this implies is that concepts of fair profit cannot be divorced from those of mutuality. What is deemed to be an appropriate distribution of benefits and participation of different groups in the determination of the objectives of the firm will determine what is a fair profit. Organisations that emphasise the interests of its employees over the protection of natural capital will have very different levels of fair profit. What is fair is what is deemed right and what is right is not just what is left.

The bottom line is that the concept of fair profit should be developed in the context of what mutuality means in terms of both the distribution of the benefits and the control of the organisation. It will fall naturally out of the concepts of capital that are being developed and the relative significance that is attached to each of them.

Colin Mayer
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Saïd Business School

Saïd Business School at the University of Oxford blends the best of new and old. We are a vibrant and innovative business school, yet deeply embedded in an 800-year-old university. We create programmes and ideas that have global impact. We educate people for successful business careers, and as a community seek to tackle world-scale problems. We deliver cutting-edge education programmes and ground-breaking research that transform individuals, organisations, business practice, and society. We seek to be a world-class business school community, embedded in a world-class university, tackling world-scale problems.

Mars Catalyst and the Economics of Mutuality programme

Mars' approach to business has been guided by Five Principles – Quality, Responsibility, Efficiency, Freedom and Mutuality for a long time. Together they inform and guide the actions of all Mars associates every day as they do their jobs and interface with the outside world.

The origins of the Mutuality principle go back to 1947 when Forest Mars Snr who led and grew the business through the 1920's to the1960's, wrote a letter to all the then 500 associates of the company that said that the sole purpose of the company was to create a mutuality of benefits with all stakeholders that the company touched from suppliers to customers as well as governments and competitors and naturally associates and shareholders. This far-sighted thinking, that the company could only be successful if everyone around the company was being successful, has been a cornerstone of our business philosophy ever since.

Mars has therefore always been interested in how it can best live up to this principle and find new ways to drive mutuality with all stakeholders it touches. This led, a number of years ago, to Mars leadership tasking Mars' economic research unit, Catalyst, to start new work into unexplored territory for business to identify critical drivers of mutuality and to develop and test through business pilots new metrics and management practices that can help boost mutuality in business situations. This work has been called the Economics of Mutuality.

This work has established promising links between increasing social, human and natural capital (that can be measured with simple & stable metrics) and thereby increasing financial capital – demonstrating how a company can do both good and well at scale. A number of pilots have now been completed in the area of micro–distribution, the employees of Mars and in agricultural development that suggest that these relationships are true in different places and situations.

The Oxford Mars partnership

On the back of these promising findings, a multiyear partnership with Oxford University's Said Business School was established in 2014 to focus on the development of a business management theory for the Economics of Mutuality with corresponding teaching curriculum, new management practices, and case study research. The research programme has combined the pursuit of normative questions – what is mutuality and how should it be enacted? – with grounded, ethnographic research on current thinking and practices. This has led to the development of field experiments and case studies examining how large corporate actors conceive of and pursue responsible business practices, and how these relate to their financial and social performance.

The broader idea being to demonstrate that businesses based on mutuality, that look to ensure all stakeholders are successful, can be more successful than businesses that focus on just their shareholders.

The intent going forward is to continue to research this topic and create a broader platform where other companies and academic institutions can share their learnings and experiences to advance the collective understanding of how to drive mutuality in business.

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