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# The Social Function of Accounts

Reforming Accountancy to Serve Mankind

John Flower



# The Social Function of Accounts

*The Social Function of Accounts: Reforming Accountancy to Serve Mankind* argues that accountancy, as currently organized and practiced, is failing society, both in Britain and in the world as a whole. Examining the current problems afflicting the world—financial crises and instability, global warming, degradation of the environment, growing inequality—this book asks the question, What contribution does accountancy make to the solution of these problems? The book argues that the accountancy profession does not serve the public interest, notwithstanding its claim to this effect. It is tied to the paradigm of modern financial capitalism with its reliance on market solutions and the maximization of the firm's profits, which are the fundamental causes of most of these problems.

*The Social Function of Accounts* analyzes the moral responsibility of the accountant with reference to the principal theories of ethics. It argues that the individual accountant has a moral responsibility to consider the impact of his or her actions on other people and on society as a whole. For accountants to properly fulfil this responsibility, it is necessary that they develop new forms of financial reporting that measure the impact of businesses on stakeholders, on society and on the environment. The book sets out the principles on which a reformed accountancy should be based. Concluding with a call for the accountancy profession to adopt a new ethic of service to the public, *The Social Function of Accounts* redraws the boundaries of current accounting literature and will be vital reading for academics, researchers and policy makers in accounting and related disciplines.

**John Flower**, now retired, was formerly Professor of Accounting at the University of Bristol and Director of the Centre for Research in European Accounting, Brussels.

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John Flower

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# Preface

The argument in this book is based on a very simple premise—that accountancy (my profession) should serve the whole of mankind, and not solely a limited group of capitalists. The book's focus is on the financial statements of business firms (financial reporting), and I am strongly of the opinion that the accountants who prepare and audit these financial statements have excessively modest objectives—they should be more expansive and more ambitious. They should strive to serve not only the people who provide the capital (the shareholders) but, in addition, all people connected with the business—referred to in this book as stakeholders.

The impulse that led to the writing of this book was a thought that suddenly struck me some 18 months ago. I was reflecting on the world's problems: world poverty and hunger, climate change, growing inequality and so on—a depressingly long list. I asked myself what contribution accountancy was making to the solution of these problems, and the answer shocked me. After considering all sides of the matter, I came to the conclusion that accountancy was making them worse! Accountancy was, on balance, a destructive force, both of society and of the environment. As an accountant I was profoundly embarrassed by this discovery and asked myself what could I do to change the situation—to turn accountancy from a destructive force into one that served mankind. I decided that, in my situation, being over 80 years of age and having retired from active life over 20 years previously, the best I could do was to write a book.

So here is the book. It is addressed to my fellow accountants. I do not expect them to agree with every word. But I would ask them to give serious consideration to my arguments, for I am convinced that, in this book, I set out a strong case for the fundamental reform of accountancy that would be necessary to transform accountancy into a force that serves the whole of mankind.



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# 1 Capitalism in Crisis

The themes of this book are that the present economic system, based on capitalism, is failing mankind, that it should be reformed and that accountancy, my profession, can make a significant contribution to its reform. In this opening chapter, I analyse capitalism's current failings, which I consider to be so serious as to merit the label 'crisis'. The analysis relates principally to the position in Britain and the USA, with occasional references to the other parts of the world.

## 1. Capitalism's Successes

Although I consider that capitalism in Europe and America is currently in crisis, I do not deny that, in earlier periods, it was a force for good. This case is well put by Edmund Phelps in his book *Mass Flourishing*.<sup>1</sup> Phelps bases much of his argument on historical analysis, particularly on movements in real wages. He cites recent research which indicates that, in England, there was no significant increase in output per worker between 1500 and 1800, but that output per head started to increase rapidly around 1820. Two British researchers claim that '*after prolonged stagnation, real wages . . . nearly doubled between 1820 and 1850*'.<sup>2</sup> A similar increase occurred at around the same time in the USA, followed in the 1830s by Belgium and France and in the 1850s by Germany. These increases in output per head were extraordinarily rapid and quite unprecedented. They were dubbed by Walt Rostow, the economic historian who first drew attention to them, as 'take-offs'—take-offs from flat economic performance to sustained economic growth.<sup>3</sup> Phelps sings a hymn of praise to the results of this take-off: '*To countries where it came . . . [it] brought immense material benefits. In raising wage rates, it provided increased numbers the dignity of self-support, it liberated them to get out into society, and it opened up city life as an alternative to rural ways. In raising incomes, it improved living standards in very basic ways, reducing risks of early death through disease*'.<sup>4</sup>

There is no doubt that the early nineteenth century witnessed a significant increase in output in certain countries. But there is continued controversy as to the causes of this increase. Phelps attributes the increase in output to

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the business environment in Britain and the USA, the two countries that led the charge. In both countries, a businessman who had an idea for a new product or process had the opportunity, the means and the freedom to put it into practice. In effect, three indispensable elements of a successful capitalist economy came together: a set of enterprising and determined businessmen with ideas that they sought to implement; a stable state with an independent and effective judicial system which greatly increased the chances that contracts would be honoured; and a financial system which provided finance for the new ventures, at least in the quantities demanded by the relatively small enterprises of the period. Phelps rejects two other putative causes: increases in basic scientific knowledge and practical inventions, such as Hargreave's spinning jenny and Watts's steam engine. Personally, I do not fully agree with Phelps on this point, as I consider that both increased scientific knowledge and inventions were important factors. But I accept that, without the contribution of enterprising capitalists, their impact would have been far less. In my view, entrepreneurial capitalism was a necessary but not a sufficient condition for the take-offs in the early nineteenth century.

There can be no doubt that capitalism as practised in the period of take-off was an extremely powerful force, both in stimulating industrial output and in destroying antiquated social structures. Even Karl Marx was extremely impressed with capitalism's energy and creative power. In the late twentieth century, a vivid demonstration of capitalism's productive power was provided by China, when the ruling Communist party decided to allow businessmen to set up and operate their own enterprises and to benefit personally from their success. The Chinese leader was reported to have said that he had nothing against a successful businessman becoming 'filthy rich'. There followed an extraordinary increase in national output from which the Chinese people have undoubtedly benefited. Clearly, the recent growth in China's GDP can be attributed, almost entirely, to the working of the capitalist system as analysed by Phelps, in particular the freedom given to businessmen to set up enterprises to put into practice their plans to enrich themselves. A similar case can be made for the role of capitalism in promoting the recent growth in national output in India and in other, smaller Asian countries, such as South Korea, Taiwan and Singapore.

## 2. The Rise of Neo-Liberalism

There can be no doubt that capitalism was, on balance, a positive force in Europe and North America in the nineteenth century, and that this is still largely the case in China and India today. But, in recent years, in certain developed countries (most notably Britain and the USA), the character of capitalism has changed, with the increasing acceptance of a radical new philosophy: neo-liberalism.

### 2.1. *The Intellectual Origins of Neo-Liberalism*

Neo-liberalism was first developed over 50 years ago, by a small group of philosophers and economists; prominent among the group were Friedrich Hayek and Milton Friedman. Both won Nobel Prizes and both wrote books,<sup>5</sup> which set out very clearly and cogently the principles of neo-liberalism. These principles may be summarised as follows:

1. The freedom of the individual is paramount, with, in the words of Milton Friedman (2002, p. 5), *'freedom as the ultimate goal and the individual as the ultimate entity in the society'*.
2. The economy should be based on transactions between free individuals. Provided the transaction is voluntary, both parties benefit, for no party is obliged to agree to a transaction from which he does not benefit.
3. Transactions between individuals should be conducted on a free market, where prices are determined by the interaction of supply and demand. Market participants (both producers and consumers) should be motivated solely by their own self-interest, and, guided by Adam Smith's 'invisible hand', they will achieve the best result for mankind.
4. The owners and managers of firms<sup>6</sup> should seek to maximize the firm's profit. The firm makes a profit from its operations when the revenue that it receives from the sale of its output is greater than its outlay on its input resources. But, at the same time, the firm has increased the total market value of goods and services in the economy, in that it has converted a set of resources with a certain market value into a set of finished goods and services with a higher market value.
5. Competition between market participants assures that resources are allocated in a way that best serves mankind's needs. Competition also ensures that no individual is subject to domination by others. Friedman (2002, p. 15) argues that *'the consumer is protected from coercion by the seller because of the presence of other sellers with whom he can deal. The seller is protected from coercion by the consumer because of other consumers to whom he can sell. The employee is protected from coercion by the employer because of other employers for whom he can work, and so on'*. Competition also assures that market participants (both capitalists and workers) receive their just rewards: the capitalist's profit represents the increase in the value of society's goods and services created by his actions; the worker's wages represent (in the jargon of economists) the marginal value product of his labour—that is, the increase in the firm's output of goods and services attributable to his effort.
6. The principal economic role of the government is to ensure that the free market operates smoothly. The government should set up and maintain a legal system, consisting of legislators who define the law, judges who apply the law in specific cases and the police who enforce

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the law. An effective legal system is a necessary condition for the operation of a free market in that (i) it protects the freedom of the individual and enables him to play his allotted role in the market (whether as businessman, worker or consumer) free from the threat of violent coercion from others, (ii) it assures that contracts are honoured and (iii) it defines and enforces property rights. All three points are essential for the proper functioning of the capitalist economy. Businessmen must be able to operate without fear of violence; they must be able to rely on the promises of people with whom they deal (especially with incomplete contracts—promises to do something in the future), and they must have the confidence that they will be able to enjoy the fruits of their labours (that their property rights will be respected). Neo-liberals accept that a state with these limited functions (often termed ‘the night-watchman state’) is absolutely necessary for the economy to flourish.

7. Some neo-liberals consider that it is appropriate to extend the government’s function to include action to *improve* the functioning of the free market—for example, by curbing monopolies. But, in general, neo-liberals are opposed to the government assuming further functions in relation to the economy, for example, in setting prices or undertaking specific economic activities through state bodies, such as nationalized industries. They argue that such government actions interfere with the functioning of the market, leading to inefficiency. One thing on which all neo-liberals agree is that taxation is a bad thing, because it deprives the individual of his property; it should therefore be kept to a minimum by limiting the role of government to its basic functions. Neo-liberals deny that the government should play an active role in the economy. In economic matters, the only justification for the government to restrict the freedom of the individual is to improve the operation of the free market. Hence, government action to protect the environment or to increase demand in a recession is illegitimate.

A fundamental principle of neo-liberalism is that the firm’s managers, in reaching decisions concerning the firm’s operations, should be motivated solely by the imperative to maximize the firm’s profits. The firm should have no other objective; in particular, it should not attempt to ‘do good’ by promoting the welfare of anyone other than the firm’s owner—the owner is the personification of the firm. Milton Friedman (2002) made this very clear in the following passage: *‘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, engage in open competition, without deception or fraud’*. Milton Friedman offered two arguments in support of his proposition. Firstly, that any interference in the functioning of the free market would lead to

inefficiency and a fall in the value of output, from which everyone would suffer; secondly, that the managers of firms are not morally entitled to use the resources entrusted to them by the owners for any purpose other than for the owners' benefit.

## ***2.2. Neo-Liberalism in Practice***

With the elections in 1979 of Margaret Thatcher in Britain and Ronald Reagan in the USA, the governments of both countries enacted economic policies based on neo-liberal policies. These included:

- Measures to improve the functioning of free markets, notably by limiting the power of trade unions. In both Britain and the USA, the governments used the power of the state to defeat strikes by militant trade unions—the coal-miners in Britain and the air-traffic controllers in the USA.
- Scrapping many government regulations that limited the freedom of action of businessmen, with particular emphasis on lifting restraints on the financial sector. In Britain, the Thatcher government deregulated foreign currency transactions and oversaw the 'Big Bang'—the wholesale removal of restrictions on the trading of securities on the London Stock Exchange in October 1983.
- Curtailing the role of the government in the economy, for example, by privatising nationalized industries and by cutting the level of state aid and subsidies to industry.
- Reducing the level of taxation, particularly on higher incomes and on business profits.

The basic principle followed by both governments was that the growth of the economy should be encouraged by stimulating the enterprise of businessmen; this was to be achieved by removing restraints on their actions and allowing them to retain a greater share of their profits.

## ***2.3. The Case for Neo-Liberalism***

Neo-liberalism's advocates use two arguments to justify their position:

- That the freedom of the individual to undertake economic activity is of fundamental importance. It should be limited only in exceptional circumstances, principally to prevent harm to other people, in accordance with John Stuart Mill's harm principle.<sup>7</sup> Hence, it is claimed that neo-liberalism has a sound moral basis.
- That the operations of the free market lead to the maximization of the output of goods and services from which everyone benefits. Hence,

neo-liberalism is economically efficient. It leads to sustained economic growth, which is in everyone's interest.

I deal with the issue of the morality of neo-liberalism later, after I have considered the question of economic growth.

### 3. Is Economic Growth Good for Mankind?

I now consider the question of whether economic growth is good for mankind. Many people consider that an increase in the output of goods and services is highly desirable, for the overall material standard of living of the population depends on this output. But I am very sceptical that a continuous increase in GDP (as currently measured) is in mankind's best interest. I consider that continuous economic growth has at least three negative consequences for mankind:

- It promotes materialism;
- It harms the environment;
- It is unsustainable and thus harms future generations.

#### 3.1. *The Promotion of Materialism*

Economic growth is clearly a 'good thing' when it enables people's basic needs to be more fully met: needs for food, clothing, shelter and so on. But capitalism recognises no limits; each year, it is obliged to invest in further productive capacity in order to avoid a slump caused by insufficient demand.<sup>8</sup> This entails that, even when their real needs have been more than fully met, the people must be persuaded to buy more goods and services—newly created goods and services which they do not really need and are only induced to buy through manipulative advertising, which in its use of psychological techniques borders on brain-washing. The result is a society obsessed with the acquisition of material goods, where the population is engaged in a never-ending pursuit of the latest gadget that will bring (all too brief) happiness. As through economic growth, more and more of mankind's real needs are met, the innovative goods and services developed by capitalist firms become ever more trivial.<sup>9</sup>

Personally, I hold that the really important things in life are not material goods. I prefer immaterial experiences, such as listening to Beethoven's Ninth Symphony or reading a Jane Austen novel. The standard answer of the economist to this comment is that 'you can't eat a novel', but the economic output in Britain and the USA has reached a level where man's basic needs have been more than adequately met: for example, the need for food is met with such excess that obesity is a far greater social problem than malnutrition. We desperately need an economic system that put the emphasis on the really important things in life.

### 3.2. *The Harm Inflicted on the Environment*

For mankind to flourish, the earth's biosphere (the narrow band of atmosphere, sea and land that supports all life on this planet) must be maintained in good condition. But there is strong evidence that the biosphere is becoming increasingly degraded, with the consequence that it is becoming less capable of supporting human life. The most worrying aspect of this degradation is climate change.

*Climate change:* The earth is becoming warmer. Incontrovertible evidence of this fact is provided by the reports of the Intergovernmental Panel on Climate Change (IPCC), a UN body which draws on the expertise of over 800 scientists world-wide. According to its latest report (IPCC, 2014), the period 1983–2012 was the warmest 30-year period of the last 1,400 years. More recent measurements indicate this trend has continued, with 2015 being the hottest year on record. The consequences for the welfare of mankind are already apparent and are almost entirely negative. They include: a significant rise in the sea level; an increase in the frequency and intensity of severe weather events, such as hurricanes; and a change in weather patterns, with some regions becoming more prone to drought, with, on balance, a negative impact on agricultural crop yields.<sup>10</sup> Up to now, the impact of climate change has been relatively benign, but the future impact will certainly be much more severe. If present trends continue (if mankind does not radically change its behaviour), the IPCC estimates that, by 2100, the global temperature will have increased by a further 3°–4°C. The forecast consequences of such a rise are dramatic. They include: a further rise in sea levels of up to 0.82 metres, leading to the disappearance of many island states (for example, the Seychelles), the inundation of vast coastal areas that are home to millions of people (for example, in Bangladesh) and the flooding of many important cities (for example, New York and London), a further pronounced increase in the frequency and intensity of extreme weather events and, most worryingly, great risks for food production, leading to widespread starvation.

The IPCC's findings are disputed by 'climate-change sceptics', whose principal arguments seem to be that weather is inherently variable, that current developments can be explained by this variability and that, given that it is impossible to know the future, the catastrophe predicted by the IPCC may never happen. I reject these arguments. The IPCC bases its findings on the work of over 800 scientists from around the world. Evidence for current climate change is based on observation of long-term trends, in some cases going back more than 200 years. Estimates of future developments are based on reasoned extrapolation of current trends, using models that have been thoroughly tested. There is a remarkable degree of consensus among scientists as to the reality of global warming, as is made very clear in the IPCC's report, which specifies very clearly the high degree of confidence that may be attached to each of its predictions. Climate-change sceptics are a tiny idiosyncratic minority.



There is no dispute about the cause of climate change. It is the consequence of the build-up of greenhouse gases in the atmosphere which trap the sun's heat. The principal greenhouse gas is CO<sub>2</sub>, which is emitted in the burning of fossil fuels, notably coal, oil and natural gas. Increased economic activity leads to increased demands for energy, which is won principally from the earth's reserves of fossil fuels. The concentration of CO<sub>2</sub> in the atmosphere has increased from 315 parts per million in 1957 to 407 parts per million in 2016.<sup>11</sup> Economic growth inevitably leads to increased demand for energy, which leads to further emissions of greenhouse gases, which lead to climate change. Renewable sources of energy, such as hydro-electricity and wind turbines, which do not pollute the atmosphere, provide only a negligible proportion of mankind's energy demands. Neo-liberalism, with its emphasis on continued economic growth, is thus a principal factor in stimulating climate change.

Climate change is only one aspect of the global environmental crisis. Other disturbing elements are:

- *Loss of biodiversity:* The earth is host to an enormous variety of life: mammals, reptiles, birds, fish, molluscs, worms, insects, trees, plants, fungi, algae and a profusion of micro-organisms. The health of the biosphere depends on maintaining an equilibrium between these various organisms. Although, in many cases, scientists are unsure of the role that any specific organism plays in maintaining the equilibrium of any particular eco-system, it is nevertheless clear that the elimination of any organism may have unpredictable and probably negative impact of the eco-system's functioning. Hence, the extinction of any life form, however insignificant, represents a potential threat to man's well-being. It is true that, over the four billion years of the earth's history, many species (such as the dinosaurs) have become extinct, but the present rate at which extinction is occurring far exceeds past rates. It is abundantly clear that the cause of the current mass extinction is human economic activity, notably the destruction of natural habitats in order to provide land for cities and agricultural production. Many scientists are concerned that ultimately mankind will suffer, perhaps profoundly, through this wanton reduction in the variety and diversity of nature.
- *Degradation of the oceans:* Over the last 50 years, there has been a significant decline in the ability of the oceans to support marine life, with serious consequence for their capacity to serve as a source of food. A major factor is increased acidification; the IPCC estimates that, since the beginning of the industrial age (c. 1750), the oceans have become 26% more acidic.<sup>12</sup> This development is linked to the increased concentration of carbon dioxide in the atmosphere and hence to climate change. Other factors have aggravated the damage caused by acidification, notably

the destruction of fish stocks caused by uncontrolled over-fishing and the pollution of the oceans, as they have become the dumping ground for mankind's waste (ranging from plastic bags to radioactive materials from nuclear power stations<sup>13</sup>) and the toxic by-products of industrial and agricultural production.

- *The abused land:* In very much the same way as has happened with the oceans, much of the earth's land surface has been damaged by human economic activity. This is particularly the case with the Amazon and Congo basins, where vast tracts of rainforest have been cleared to release land for agriculture. The long-term results are generally negative. Certainly, initially the virgin soil produces high yields, but these drop off as the soil's fertility is depleted through continued intensive cropping. Elsewhere, whole regions have been ravaged by industry's demand for raw materials: for example, the development of the Athabasca oil sands in Canada has created an artificial lake of toxic wastewater over 77 km<sup>2</sup> in area,<sup>14</sup> and strip mining in Appalachia literally destroys the landscape, with whole mountaintops being removed in the search for coal.<sup>15</sup> In many parts of Africa, vast tracts of land have been used as the dumping ground for the richer countries' waste and discards, such as used television sets. In the graphic word of Pope Francis, '*the earth, our home, is beginning to look more and more like an immense pile of filth*'.<sup>16</sup>

The principal cause of the damage to the environment is human economic activity. There can be no doubt that, in recent years, human activity has caused significant damage to the biosphere, with very serious consequences for mankind's future welfare.

The above analysis implies that capitalism, through the stimulus that it gave to the development of industrialization (see Phelps's thesis in section 1 above), has been a major factor in causing the current environmental crisis and, with its emphasis on ever-increasing output, is likely to remain a negative influence in the future. More seriously, for reasons that I set out later (see section 4), I consider that capitalism is incapable of modifying its behaviour so that the increased output is produced in ways that do not harm the environment.

### 3.3. *The Harm Inflicted on Future Generations: The Need for Sustainability*

Continuous economic growth cannot be sustained in the long run, because it fails to take into account the limits of planet Earth. There are two types of limits: the limited quantity of the non-renewable resources (such as fossil fuels) which are used up in the production process, and the limited capacity of the earth to absorb the waste generated by economic activity (both

industry's unwanted by-products—for example, the toxic effluent of a chemical factory—and the discards of the consumption-obsessed society created by capitalism, such as the plastic bags that presently befoul the oceans).

The coal, oil and natural gas which currently supply industry's energy requirements were created over several million years; they are now being consumed at such a rate that the entire stock will be used up in a few hundred years. This rate simply cannot be sustained.<sup>17</sup> Jonathon Porritt (2005, pp. 46–50) points out that the economy depends on the biosphere—the economy is a subsystem of the biosphere's ecosystem. He concludes, *'It is the physical limits of the ecosystem which will constrain the speed and scale at which the economic subsystem can expand. In the long run, it cannot grow beyond the capacity of the surrounding ecosystem to sustain that growth—and the planet (or overarching ecosystem) cannot grow'*.

The gravest threat to future generations is posed by climate change resulting from the build-up of greenhouse gases in the atmosphere. It is estimated that, with the present concentration of CO<sub>2</sub> in the atmosphere of more than 400 parts per million, the average global temperature will increase by over 4° C by the end of the present century, with devastating consequences, such as the flooding of coastal regions (and the disappearance of some island states) caused by a rise in the sea level, and famines caused by changes in the weather pattern.

Porritt also points out the implications of compound growth. If the economy grows 3% this year, and at the same rate in future years, in 25 years it will be more twice its present size,<sup>18</sup> and, with no change in the behaviour of firms, there will be double the consumption of oil and other raw materials and double the creation of waste.

The first thinker to draw attention to the dangers of compound growth was Thomas Malthus, who, in 1799, published an essay which analysed the consequences of population growth.<sup>19</sup> He pointed out the incontrovertible fact that, if population grew at a compound rate, it must at some point outstrip the earth's capacity to feed itself, leading inevitably to famine. In Malthus's day, Britain's population was growing at about 1.4% per year. At that rate the world's population would grow from about 1 billion in 1800 to about 17,000,000 billion in the year 3000, which would leave less than 10 square centimetres of land for every man, woman and child to stand on! Of course, this cannot happen and, in fact, largely due to the spread of contraception, the world's population is expected to stabilise at around 10 billion in the year 2100. But this analysis vividly illustrates that compound growth is incompatible with finite resources.

It seems abundantly clear that the current rate of economic growth cannot be maintained even for more than a few decades without a fundamental change in the way the economy functions. But the people who will suffer most are future generations; by contrast, the current generation may probably suffer only relatively minor inconveniences, such as more frequent heat waves and hurricanes. But it is thoroughly immoral for the present

generation to enjoy the pleasures of an extravagant lifestyle (including such energy-consuming activities as air-conditioning and air travel to exotic holiday-destinations) when it is future generations which will have to bear the cost in the form of climate change.

What is needed is not a growing economy, but a stationary economy, as first proposed by the English philosopher John Stuart Mill in 1850 and in this generation by the economist Herman Daly.<sup>20</sup> But I contend that, for reasons to be given in section 4, neo-liberalism is incapable of weaning itself from continuous growth.

### **3.4. *Neo-Liberalism's Answer***

The answer of the neo-liberals to my predictions of imminent catastrophe is basically similar to the reaction of Mark Twain to newspaper reports of his death—‘greatly exaggerated’. The catastrophe has not yet happened and may never happen. In fact, currently, more people enjoy a higher material standard of living than ever before in the history of the world. For example, over the past two years, the number of people suffering from malnutrition has declined by 20%. This has been achieved by mankind’s genius for invention and innovation, for example, in developing new strains of cereals that give higher yields per acre. Given man’s experience over the past 200 years, there is every reason to expect that mankind will continue to enjoy ever increasing prosperity: for example, that he will develop new forms of energy that are less polluting and thus reduce his dependence on fossil fuels. New modes of living can be developed that provide increased satisfaction for everyone but are less dependent on the production of material goods; for example, computers and smartphones have become progressively more powerful, as they have become smaller and thus use fewer materials. The dire predictions of Thomas Malthus have not been realised (at least, not in the two centuries since they were made), and the same will be the case with my predictions.

### **3.5. *My Response***

I concede that the neo-liberals may well be correct. Both they and I are talking about the future and, in the immortal words of Yogi Berra, *‘it is always difficult to make predictions, particularly about the future’*. But I stick by my contention that unchecked capitalism is driving mankind to catastrophe—for two reasons:

- I do not believe that the developments on which the capitalists pin their hopes (new forms of energy and less material-intensive modes of consumption) can be achieved in time to save the world from disaster. If the billions of people in China, India and other developing countries realise their aim of a standard of living equal to the current level of America and Europe, then pollution created by the extra billion cars,

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air conditioners and other material attributes of a high standard of living will surely make global warming even more likely and even more destructive.

- I believe that it is prudent and rational to take action to prevent a catastrophe, even if the probability of a catastrophe is small. This is known as the precautionary principle. It is logical to incur a certain small cost now in order to avoid a far greater (but uncertain) harm in the future.

I do not advocate abandoning completely the aim of further material progress, but I do consider that the type of unrestrained economic growth induced by neo-liberal policies must be stopped. I believe that neo-liberalism is incapable of achieving this.

### 4. Neo-Liberalism's Fatal Flaws

It should be noted that the arguments against economic growth set out in the previous section apply not only to neo-liberalism, but to all forms of capitalism. But the potential harm to mankind from neo-liberalism is far greater than that from traditional capitalism because of two flaws in neo-liberalism's fundamental principles:

- The limitation of the role of the state;
- The absolute freedom of the businessman.

#### 4.1. *The Limited Role of the State*

It is a fundamental principle of neo-liberalism that the state's functions should be limited to those of the night-watchman state—to defend its citizens from aggression (either from foreigners or from their fellow citizens), to ensure that contracts are honoured and to protect property rights. State action beyond these functions is illegitimate. Hence, when the application of neo-liberal policies leads to consequences that may be considered to be undesirable, there is no way of correcting the position. It is my contention that traditional capitalism (as practised before the introduction of neo-liberalism a generation ago) was prevented from causing serious harm to society through the timely intervention of the state. A pertinent example is the recovery from the Great Depression of 1929–1933 through government action: for example, Roosevelt's New Deal. A somewhat similar situation arises currently in relation to climate change, as explained in the next section.

#### 4.2. *The Unfettered Freedom of the Businessman*

One of neo-liberalism's fundamental principles is that the individual businessman (and firm) has an absolute right to increase his wealth by exploiting the opportunities available to him on the market—to buy resources (such

as materials and labour) at market prices, convert them into finished goods and services using any available technology and sell them to consumers and other firms at the highest price that he can get. The principal constraints that he has to respect in the pursuit of his private wealth are those imposed by the market—for example, he cannot force other firms to sell him materials at less than the market price. Of course, in addition, he is obliged to obey the law. But the law originates from government, and, as pointed out above, neo-liberals reject the legitimacy of government action that restricts the freedom of firms to maximize profits; the only legitimate constraints are those imposed by the market.

The implication of this ideology is that the businessman, in making decisions about what to produce, how to produce it and how much to produce, takes into account only the impact of his decisions on his own wealth and ignores the impact on the welfare of other people; he considers the impact on other people *only* to the extent that it has an impact on his own wealth—for example, a businessman would not market a dangerous product, if, this fact becoming widely known, customers organized a boycott.

The implications of such behaviour may be demonstrated with the following example. A firm uses a large quantity of electricity in its production process. The generation of electricity entails the production of CO<sub>2</sub> which, when released into the atmosphere, causes climate change. But the quantity of CO<sub>2</sub> emissions varies according to the method used to generate electricity, from negligible, in the case of wind-turbines, to considerable, for a coal-fired power station. But the market price of electricity does not reflect these differences; in fact, in most European countries, the user has to pay a premium if he wants to be certain that the electricity that he consumes has been generated in a less polluting way. The capitalist businessman has no incentive to pay this premium. His sole interest is to acquire the electricity required by his firm at the lowest price available on the market. Certainly, he and his firm will suffer the consequences of climate change in the far future, but the relatively small quantity of CO<sub>2</sub> produced in generating the electricity that his firm uses will have a negligible impact on the climate; his present behaviour will have virtually no impact on his future suffering, which will be determined by the behaviour of millions of other people.

The fundamental flaw in neo-liberalism is that decisions on resource allocation are taken at the level of the manager of the individual firm. In very many cases, this is not the level that leads to the best decision for mankind. Other levels are more appropriate: the community, the country and (in the case of climate change) the level of the planet.

#### *4.3. The Consequences of These Flaws*

I contend that, because of these flaws, the performance of the British economy over the past generation (when economic policy was based on neo-liberal

principles) has been seriously deficient and harmful to society. I will justify this claim with reference to the following matters:

- Unemployment;
- Inequality;
- Financialization;
- The global financial crisis of 2007/8.

## 5. Unemployment

Over the last 40 years, unemployment in Europe has been getting worse. Over this period, the unemployment rate in Britain worsened from 3.4% in 1974 to 5.0% in 2016 and in Germany from 1.7% in 1974 to 4.2% in 2016. The date of 1974 has been chosen as it represents the end of a remarkable 30-year period in the economic history of Western Europe and North America, known to the French as the ‘Trente Glorieuses’, which was marked both by a substantial increase in output and by a significant improvement in the living conditions of the poorest members of society. Since 1975, the unemployment rate in Europe has fluctuated significantly; for example, in Britain, it reached a high point of 11.9% in 1984 and a low of 4.7% in 2004,<sup>21</sup> but it has never recovered the very low levels (around 2%) experienced in the 1950s and 1960s.

The evidence that neo-liberalism has caused unemployment is not wholly convincing. Thus, the level of unemployment in Britain in 2016 was lower than that in France, notwithstanding that Britain has adopted a far more aggressive form of neo-liberalism. But I feel that the longer-term development since 1974 gives the more substantive picture. It is surely no coincidence that unemployment started to increase with the adoption of neo-liberal policies by Margaret Thatcher (who became Britain’s Prime Minister in 1979) and Ronald Reagan (elected US President in the same year).

The evidence that neo-liberalism has caused a deterioration in the conditions of employment is much more convincing. In Britain, the current level of unemployment is not excessively high at 5% (although far higher than the average rate of 2%–3% enjoyed during the ‘Trente Glorieuses’). But there is no doubt that the working conditions for the great majority of those in employment have worsened considerably, as demonstrated by the following developments:

- A significant reduction in the security of employment. Thus, many people are employed on temporary contracts, some even on ‘zero-hours’ contracts, where the employer pays only for the hours worked and offers no guarantee that work will be forthcoming.
- A significant increase in the number of hours worked by those in permanent employment. This is a paradoxical trend, given the continued spread of labour-saving technology. Possibly it can be explained by the desire

of managers to reduce to a minimum the number of their permanent employees (those which they are obliged to employ even when business is slack), with the consequence that those who escape being sacked have to work even harder. It would seem that, in Britain, the working population is divided into two disparate groups: the overworked permanent employees and the underworked employees on zero-hours contracts.

- A change in the form of pension schemes offered by firms to their permanent employees. There has been a pronounced shift from defined-benefit pension schemes (where the risk is borne by the employer) to defined-contribution pension schemes (where the risk is borne by the employee).

There is no doubt that, with neo-liberalism, the employment experience of the great majority of the British population has worsened.

## 6. Inequality

The argument is that neo-liberalism creates a more unequal society, with greater differences in wealth between the rich and the poor. Neo-liberals acknowledge that, for them, a more equal society is not an important aim. In the choice between a more free society and a more equal society, neo-liberals come down unequivocally in favour of a more free society; the freedom of the individual should never be constrained in the interests of equality. Hence, for the neo-liberal, redistributive taxation—taking from the rich to give to the poor—is anathema.

But neo-liberals claim that, in their ideal economy, in which firms have complete freedom to maximize their profits, all (including the poor) benefit from the increased output of goods and services. The neo-liberal position was very well expressed by the British vice-chairman of Goldman Sachs, when, in defending the bonuses totalling \$16 billion which his firm planned to pay, asserted that the public should ‘*tolerate inequality as a way to achieve greater prosperity for all*’.<sup>22</sup> The neo-liberals claim that wealth will ‘trickle down’ to the poorer elements in society or (to change the metaphor) ‘a rising tide lifts all boats’. This certainly seems to have been the case in China, where millions of citizens, who previously lived a very basic life in the countryside, have undoubtedly benefited from the surge in prosperity resulting from the introduction of capitalism. But the critics of neo-liberalism have two counter-arguments:

- ‘Trickle down’ does not always work;
- There are other failings of an unequal society.

### 6.1. The Failure of ‘Trickle Down’

The neo-liberals’ principal justification of an unequal society is that, in practice, it leads to a higher material standard of living for everyone, including