

**free
enterprise
group**

making the case for free enterprise



The Case for Real Capitalism

by Jesse Norman, Member of Parliament for Hereford and South Herefordshire

Contents

Executive Summary

1. **The Case for Capitalism**
2. **Crony Capitalism**
3. **The Case of Goldman Sachs**
4. **Lloyds HBOS and the UK banks**
5. **Pay**
6. **The UK's Real Economic Decline**
7. **Institutions: AWOL or MIA?**
8. **The Politics of Crony Capitalism**
9. **Free Market Conservatism**
10. **Lessons**

About the author

Jesse Norman is the MP for Hereford and South Herefordshire, and a member of the Treasury Select Committee. He is a former Director of BZW, which he left in 1997; and of Institutional Shareholder Services, now the leading provider of corporate governance advice worldwide.

Executive summary

- Capitalism is the greatest tool of wealth creation, social advance and economic development ever known.*
- We are living through a period of crony capitalism, of which the Goldman Sachs flotation and Lloyds-HBOS merger are just two examples.
- Conservatives must make the moral case for real capitalism, and take action against crony capitalism — and the culture that created it.

* Please note a longer version of this paper is in preparation.

1. The Case for Capitalism

The US economy is stagnating. The Eurozone is in crisis. The UK may be dragged back into recession. This crisis is not a mere economic downturn, but a fundamental shift of value, caused by excessive financial speculation and abetted by foolish political decision-making over two decades. Capitalism itself is widely held to be at fault.

In fact capitalism is the greatest tool of economic development, wealth creation and social advance ever known. In capitalism, owners of intellectual, financial or human capital have property rights that enable them to earn a profit as a reward for putting that capital at risk in some form of free market economic activity.

Korea used to be one country. Thirty years after the Korean war, GDP per capita in capitalist South Korea was five times that of communist North Korea; in 2009 it was sixteen times greater.

But the case for capitalism is not just economic and social; it is also moral. For many decades, capitalism has come under attack on moral grounds. It is said to be intrinsically immoral, and driven by greed; to be founded on theft, with the greatest capitalists mere “robber barons”; to create and perpetuate exploitation and inequality; even to be morally vacant.

Of course abuses of capitalism often occur. But the bigger truth is that capitalism is at root a moral force for good. It relies on, and so demands:

- a. Personal freedom and individual autonomy, the foundation stones of personal morality;
- b. The virtues of hard work, creativity and thrift;
- c. Social exchange: traditions and practices by which intellectual, financial and human capital can be shared to best effect;
- d. Institutions such as the rule of law and the family that preserve property over time;
- e. Effective government to create and enforce the law, to share social costs and, I would argue, to help the disadvantaged;
- f. A wider culture and a stable but fluid social order in which its virtues are respected and opportunity exists for all of energy and talent, that is for all.

In short, capitalism relies on, and so demands, trust. It does not exist to make the rich richer.

But there is a huge But. This is real capitalism, capitalism as it's supposed to work. That's not the capitalism we have in the UK at present. What we have now, in large parts of the UK economy, is crony capitalism.

2. Crony Capitalism

What is crony capitalism? One can identify different varieties, such as monopoly, franchise, khaki and narco-capitalism:

- *Monopoly capitalism* flourished in the USA at the end of the 19th century. At that time individuals such as Cooke, Vanderbilt and Rockefeller were able to amass enormous wealth by agglomerating new industries into “trusts”, which exercised monopoly or oligopoly market power within markets.
- *Franchise capitalism* developed in Russia during the 1990s. A generation of “oligarchs” emerged, alongside the official apparatus of the state, whose wealth derived from winning lucrative natural resources franchises in oil and gas.
- *Khaki capitalism* has taken root in countries such as Egypt and Pakistan, where the armed forces have become large economic actors in their own right. In Egypt, for example, the army runs roughly 10 per cent of the economy.
- *Narco-capitalism* has been seen in recent decades in Mexico and Colombia, among other countries. The drugs trade created enormous illicit profits for its chiefs. As the trade became a substantial part of a regional or national economy, it was further entrenched through corruption.

These varieties can and do often co-exist in a given country or society. They all exploit the absence of law or law enforcement, market mechanisms or culture which act elsewhere as constraints on individual self-enrichment.

More generally, one might say crony capitalism has two key features:

- a. Business activity loses any relation to the wider public interest
- b. Business merit is separated from business reward.

By contrast, real capitalism is a system where real people take real risk, invest real time in real work and reap real rewards for their efforts. A day’s work for a day’s pay. Markets are used, but not venerated. Competition is welcomed, but made subject to proper regulation and supervision. People are rewarded and respected for their aspiration, energy and innovation, not for who they are.

This country is emerging from a time of fake capitalism, matched by fake government; a time when Fred Goodwin could destroy an august 200-year old financial institution and

squander billions in shareholder value, then walk away with a fortune and have a government minister sign off on his pension.

Crony capitalism is what happens when the constraints of law and markets and culture cease to be effective. Entrepreneurship and value creation are replaced by rent-seeking, and certain groups become enormously wealthy without taking risk. These factors in turn lead to long-term economic underperformance, and sometimes to social unrest.

3. The Case of Goldman Sachs

Take the investment bank Goldman Sachs. Few other businesses of any kind have been so consistently or massively profitable, with \$20 billion in 2009 profits alone. Few other businesses have been as pious in their official pronouncements.

But few other financial institutions have so seriously breached public norms of behaviour and ethics in recent years, as acknowledged by Goldman's payment in July 2010 of a record \$550 million to settle an SEC court case for misleading investors over a sub-prime mortgage product.

The ironies are manifest, for historically Goldman was famous for being risk averse, dedicated to its clients, and shy. It was a partnership, which sought wherever possible to protect the partners' capital

But over the past twenty years the values of risk-aversion, client focus and low profile have gone by the board. During the 1990s Goldman developed a massive proprietary trading operation. Over time this became so profitable that it dominated many aspects of the firm's trading and market-making operations. Conflicts of interest became endemic. When the subprime crisis struck, Goldman only survived by becoming a bank holding company and drawing heavily on various emergency liquidity packages provided by the US government.

4. Lloyds HBOS and the UK Banks

Goldman Sachs is not merely a case study of institutional decline. It shows how vast tracts of the global financial sector have become disconnected from their original public purpose — the first mark of crony capitalism. At the same time, executive pay has rocketed — the second mark.

The same is true with the UK banks, as witness the merger between Lloyds and Halifax Bank of Scotland in 2008. Lloyds had been by some way the best-managed UK big bank of the previous two decades.

All this patient value creation was blown away by the merger in September 2008 with HBOS. Lloyds shareholders have lost some 85% of the value of their shares. The financial advisers to Lloyds had done catastrophically bad due diligence on HBOS, but collected likely fees of hundreds of millions of pounds. Some 24,000 employees have since been laid off. Sir Victor Blank, the deal's architect, has been invited to guest-edit the prestigious Today Programme on Radio 4 this Christmas.

5. Pay

But crony capitalism is not restricted to the financial sector. It can also be found in other parts of UK PLC. Many of our largest public companies have become so complacent, unaccountable and bureaucratic that they resemble bad governments.

A recently published paper shows the extent of the problem. *The total remuneration of the average FTSE 100 company chief executive has risen by more than 400 per cent over the past 12 years, to £4.2 million.* Take-home pay has more than doubled to £2.5 million since 1999, moving from 47 to 88 times that of a full-time UK employee.

It is sometimes said that pay reflects stock market performance. But the pay of FTSE 100 chief executives rose 13.6 per cent every year from 1999 to 2010, while the FTSE itself rose by an annual average of just 1.7 per cent.

Overall, no reputable study has found a significant correlation between senior executive pay and long-term corporate performance. But one correlation is well known: the bigger the company, the bigger the pay package.

6. The UK's Real Economic Decline

What about the effects of crony capitalism on the UK itself?

The years 1992-2008 have been widely feted as a great story of UK economic recovery, and in particular Labour propagandists have hailed the decade 1997-2007 as a miracle of continuous growth under Gordon Brown.

The truth is rather different. The UK is best compared with countries with a similar cultural, political and economic background, like Australia, Canada, the United States and New Zealand. *Every single one of these countries grew faster over the period 1992-2008 than the UK.*

Once the effects of immigration are factored in, it turns out that UK GDP per head in fact improved not by 50% but by 42% between 1992 and 2008. In other words, the UK's growth record was even weaker than appeared at first sight, and only just above the average 40% growth of the "sclerotic" Eurozone.

Our "economic miracle" was a mirage. It was also a distraction. The real economic story was happening elsewhere, with the rise of China, India, Russia and Brazil — the BRICs — the increasing economic control of Germany over the Eurozone, and a global shift of economic power away from the US, from the West and towards emerging markets. While the UK congratulated itself on its apparent local economic success, in reality it continued to lose ground globally.

The UK economy was bloated by an enormous burst of borrowing and leverage. Between 1960 and 2000 the loans the banks made totalled about twenty times the amount of shareholder capital they possessed. *After 2000, they started to rise vertiginously, up to nearly 50 times capital in 2007-8. When the crisis hit, the banking system was already in a desperately fragile state.*

The increase in borrowing in turn fed through into a disastrous asset bubble in housing, which all but doubled in real value over the period, and into personal debt, which soared to nearly £1.5 trillion in 2007, higher than Britain's GDP. Eighty per cent of that debt was secured on private property.

7. Institutions: AWOL or MIA?

Asset bubbles and economic shocks are not new to the UK, even on this scale. Crony capitalism did not emerge just because of the different factors described above. It was allowed to do so because a range of august public bodies, which could have restrained or shaped it, did not do so effectively. These include HM Treasury, the Bank of England, the FSA and the CBI.

8. The Politics of Crony Capitalism

An objection might be “Maybe all this stuff about crony capitalism is true. But if it is, isn’t it the Conservatives’ fault? They have always been the voice of capital, just as Labour have been the voice of labour. And it was Mrs Thatcher who deregulated the City of London in the 1980s. Our present problems spring from that decision.”

This familiar line of thought seems to have inspired Ed Miliband’s 2011 Labour conference speech, with its distinction between “predators” and “producers”. In his words “Producers train, invest, invent, sell ... Predators are just interested in the fast buck, taking what they can out of the business.” So there are obvious overlaps between Mr Miliband’s remarks and the present critique. Does this mean the objection is right?

The answer here is fairly evidently No. First, on the facts. Crony capitalism really took root in the late 1990s, when the Bank of England ceased to be responsible for systemic risk in financial markets, the doctrine of inflation targeting was institutionalised, and the banks were allowed to ramp up borrowing. These things occurred under a Labour government, ten years after Big Bang took place.

Secondly, on the politics. Historically Conservative prime ministers have in fact had a very good record of standing against corporate and financial excess. Current mythology casts Mrs Thatcher as a devil-take-the-hindmost economic libertarian. But as regards crony capitalism she was no exception to the earlier pattern of Conservative prime ministers.

She had little time for financiers in general, and saw Big Bang and the deregulation of the financial markets as a means to increase competition and end restrictive practices and cosy deals. She was intensely hostile to monopoly in any form, and attacked the management of the nationalised industries as crony capitalists of a kind. Her mantra was that ownership brought with it economic and moral benefits, and should be spread as widely as possible: “every earner an owner”, as she put it. She would not have hesitated to attack the present crony capitalism, and in the baldest terms.

9. Free Market Conservatism

But there is a deeper point. Conservatism is the product of several different interlocking traditions. At its core, it contains a profound critique of the market fundamentalism now prevalent in Western society. But, politically, it does so not from the left, but from the right. Markets are not idolised, but treated as cultural artefacts mediated by trust and tradition, which can be used to address social or economic problems. Capitalism becomes, not a one-size-fits-all ideology of consumption, but a spectrum of different models to be evaluated on their own merits. Idealism about what should be achieved is tempered by realism as what is actually possible.

Francis Fukuyama hailed the fall of communism as the end of history. But the real battle of the 21st century will be between free market neoliberalism and free market conservatism. Free market conservatism will often overlap in places with a liberal, if not neoliberal, view of free markets. Both will be innately hostile to monopoly and state interference, for example, and supportive of competition and entrepreneurship. But the two viewpoints can also come apart, especially in their respective attitudes to human behaviour, existing practices, traditions and institutions; and in their view of how change occurs. Free market neoliberalism is memoryless, since it tends to see the world mathematically and episodically, in terms of preferences and incentives operating at a given time. Free market conservatism tends to see the world as evolving continuously and organically.

Take markets: free market neoliberals value markets as such. But free market conservatives look at markets as institutions, and see an important distinction between primary markets, where goods and services are first sold, and secondary markets, where they are traded. Primary markets tend to satisfy human needs, as items like food and cars and insurance are sold for cash, while secondary markets are prone to speculation. So the conservative will instinctively prefer primary to secondary markets, and will want to free up the former and regulate speculation in the latter. The neoliberal has no principled means to prefer one to the other, and will be hostile to regulation in both.

Crony capitalism arose because British culture changed, under the influx of a neoliberal economic ideology of free markets. Its emergence shows why, in the battle between free market liberalism and free market conservatism, we must choose free market conservatism.

10. Lessons

What are the lessons to be learned? Here are nine:

Lesson 1: Conservatives need to turn up the volume on crony capitalism.

In recent years the Conservative party has developed what amounts to a strong critique of crony capitalism and its effects. Attacking crony capitalism is not anti-business, it is pro-business. Now is the time to turn up the volume.

Lesson 2: Culture matters.

The Efficient Markets Hypothesis is not Holy Writ; human beings are creatures of habit; the social order is based on traditions, practices and institutions which escape economic specification. Culture matters: in the banking system, in the UK economy, in our society.

Lesson 3: Excessive pay is a serious issue.

Pay is a litmus test of social norms, and excessive pay is a hallmark of crony capitalism. There is nothing Conservative about crony capitalism, and there is nothing specifically left wing about concern at excessive pay, in either the private or the public sector.

Lesson 4: Corporate governance isn't sexy. But it is vital.

Addressing the issue of excessive pay does not mean direct caps on private sector pay, an incomes policy or similar quack remedies of socialism. It does mean a fundamental rethink of the mechanisms of corporate governance.

Lesson 5: The banks should temporarily restrain, and perhaps cease, dividend and large bonus distributions.

The UK banking system is far better capitalised than it was in 2007-8. But it remains in an extremely precarious position, as the money markets are drying up in Europe and the US. There is a strong case for the banks to restrain, and perhaps cease, dividend and large bonus distributions, to protect their capital base and lending.

Lesson 6: We need a fundamental rethink about competition.

A sustained attack on crony capitalism demands a new and deeper look at competition, and at competition policy, to inhibit regulatory capture and rent-seeking.

Lesson 7: Key public institutions require better governance.

Over the past decade key British institutions, notably the Bank of England, the Treasury and the FSA, did not discharge adequate financial oversight and supervision of the UK financial system.

Lesson 8: The new Financial Policy Committee must have a range of tools to control asset bubbles.

Inflation targeting was not sufficient by itself to prevent asset bubbles. The Bank of England must be able to monitor areas of growth and intervene proactively where appropriate, in a way that is accountable but free of everyday political interference.

Lesson 9: We need to love our savers.

Saving is a virtuous habit. But it has been destroyed by the recent cycle of boom and bust. What can be done? The banks could start by restoring the old rule that required people to save for a minimum of two years in order to get a mortgage. The government should dust off the idea of a Lifetime Savings Account.

To sum up: real capitalism is one thing, and crony capitalism quite another. Setting the right economic incentives is important. But so are virtuous habits. If we are going to get back to real capitalism, we need to focus as much attention on our culture and values as on our economy.

About the Free Enterprise Group

Objectives

- Encourage a competitive and free economic environment
- Raise the global economic standing of the United Kingdom
- Challenge monopolies and oligopolies
- Free individuals to create, innovate and take risks

Supporters

Steve Baker MP
Steve Barclay MP
Karen Bradley MP
Aidan Burley MP
Alun Cairns MP
Therese Coffey MP
George Eustice MP
John Glen MP
Sam Gyimah MP
Matthew Hancock MP
Richard Harrington MP
Chris Heaton-Harris MP
Margot James MP
Sajid Javid MP
Chris Kelly MP
Kwasi Kwarteng MP

Andrea Leadsom MP
Brandon Lewis MP
Jesse Norman MP
Guy Opperman MP
Priti Patel MP
Mark Pritchard MP
Dominic Raab MP
David Rutley MP
Laura Sandys MP
Chris Skidmore MP
Julian Smith MP
Rory Stewart MP
Elizabeth Truss MP
Andrew Tyrie MP
Nadhim Zahawi MP



www.freeenterprise.org.uk

Contact:

Jesse Norman MP on 020 7219 7084 or jesse.norman.mp@parliament.uk
Elizabeth Truss MP on 020 7219 7151 or elizabeth.truss.mp@parliament.uk

DISCLAIMER: All supporters subscribe to the aims of the group. However, articles written under the auspices of the group reflect the author's own views and not necessarily those of all group members.