Why urgent action is needed to reform malfunctioning capitalism

I was prompted to write this piece by three articles recently printed in a national newspaper. There on the same page were three nominally unrelated stories.

The first concerned the proposed take-over of a defence technology company responsible for the sensitive task of protecting Trident submarines, the UK's nuclear deterrent, by another defence company. The acquirer had previously been British owned but was now controlled by a US private-equity fund, which had largely divested it of its UK manufacturing activities.

The second article concerned an enquiry by the competition body into collusive price rigging amongst a group of construction companies. The regulator had found customers had paid too much. The final article related to the circulation of 'best-practice' advice to auditors by their regulatory body reminding the profession of its duty to demonstrate independence in its activities.

All these come at a time when the UK economy faces major challenges in both the short and longer term. In the short term there is a real possibility of the economy moving into recession, accompanied by rising inflation and falling real incomes. In the longer term the UK is experiencing enormous challenges on key issues affecting growth; productivity is at an all-time low, not just in Wales but in most regions of the UK; capital investment is declining and expenditure on research and development lags behind competitor nations. Given these circumstances is it not surprising that one professional forecaster predicts the only country to have a slower nearterm rate of growth than ours is Russia?

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The reader may be scratching their head to understand how weak economic performance and these events are connected. In my opinion the connection to be made is that a tainted form of capitalism has evolved over a number of decades and this has led to an underperforming economy.

To be clear I am in no doubt that even with the many faults the contemporary system has exposed markets provide the most effective means of creating and distributing goods and services. Returns and rewards should be earned by those who take risks and by innovative actions providing the goods and services that consumers are happy to pay for. They achieve this by investing in capital, whether it is equipment or human capital by training the workforce, securing productivity benefits.

But the style of capitalism we experience now is what economic commentators label 'rentier capitalism'. This is the state of affairs where a disproportionate share of national income and wealth is extracted by those who live off income from property, which includes intellectual property and investments. In other words, the ability to extract disproportionate levels of 'rent' or income from everybody else. Many behave as balance sheet engineers, frequently seeking the immediate extraction of value to maintain fund returns.

This approach stands in contrast to traditional engineers who design and make things that improve society and should justifiably be rewarded for serious risk taking and ingenuity.

So how can this situation be ameliorated? Here are some thoughts which might go some way to addressing issues symbolised by the three articles. In their own way they are quite simple, but there will no doubt be some readers who would consider them a step too far.

To those people I would counter if radical steps are not taken there is a series risk economic decline will become baked into the system.

What’s needed

Introduce measures that provide greater parity between debt and equity. One reason private equity survives is because the cost of serving debt is an above the line charge. Private equity returns too often have very little to do with risk taking. A financial engineer will use a company’s assets as collateral, borrow against them and load the company’s balance sheet with debt, with very little equity or risk capital. Although there are signs debt markets may be drying up, reducing the prospect of the most rampant practices, there still remains a requirement for the tax advantages of debt over equity to be levelled up in favour of equity;

Collusive behaviour, similar to that reported to have taken place by construction companies, is clearly not in customer’s or the public’s interest. It leads to weakening competition and the prospect of monopolies developing, with impaired potential for productivity and therefore growth. It has always taken place and will continue to do so. But there needs to be a cost to this behaviour. An aggressive application by the authorities of regulations, involving executive directors and non-executives being held personally accountable for transgressions resulting in the imposition of heavy fines and jail sentences seems a small price to increase the chances that improvements in corporate behaviour might follow;

There should be no compromises over the application of governance standards. The notorious instances of Carillion and Patisserie Valerie are amongst the most egregious examples of weak audit work and inexcusable executive performance. It jeopardises the public interest and trust in the system. More generally it leads to the conclusion that a culture of lax oversight has been too easily allowed to flourish;

I don’t care what it is called, but the UK and Wales must have something that amounts to an industrial strategy. We have seen too many come and go over the last few decades to believe they might have an impact over a single electoral life cycle. A sensible strategy would recognise this is a long-term project that acknowledges what the state is best placed to influence and what is best left to the private sector. Whilst not solely for the state it will require a realistic appreciation of the skills, rewards and institutional architecture that are pre-conditions of effective implementation.

At its centre it must address the core issues of ownership, productivity and workforce and capital investment. In my opinion anything less will be certain to fail.

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