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ECONOMICS *of* PROSPERITY

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Prosperity for All

Restoring Faith in Capitalism

by Tim Montgomerie

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ABOUT THE LEGATUM INSTITUTE

The Legatum Institute is an international think tank and educational charity focused on promoting prosperity. We do this by researching our core themes of revitalising capitalism and democracy. The *Legatum Prosperity Index™*, our signature publication, ranks 142 countries in terms of wealth and wellbeing.

Through research programmes including The Culture of Prosperity, Transitions Forum, and the Economics of Prosperity, the Institute seeks to understand what drives and restrains national success and individual flourishing. The Institute co-publishes with *Foreign Policy* magazine, *Democracy Lab*, whose on-the-ground journalists report on political transitions around the world.

The Legatum Institute is based in London and an independent member of the Legatum Group, a private investment group with a 30-year heritage of global investment in businesses and programmes that promote sustainable human development.

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Foreword

Prosperity for All is an assessment of the health of capitalism originally published online in November 2015.

Chapter One reviews the failure of the anti-capitalists to overthrow the system after the 2008 crash—but it also argues that reform is still needed and that the laissez-faire opponents of reform actually represent the biggest threat to capitalism.

Chapter Two lists the achievements of capitalism and the public's ignorance of them. This extra section lists eight great characteristics of enterprise societies.

Chapter Three calls for a rediscovery among economists and the centre right of the real Adam Smith—a thinker who was more interested in moral conduct than free market forces.

Chapter Four looks at the importance of social capital and asks if we need new measures to assess social and economic progress.

Chapter Five examines the role of business leaders in creating a more popular capitalism and whether they should pursue purpose as much as profit.

Chapter Six on the inefficiency, inequality and inequity produced by crony capitalism.

Chapter Seven argues that inequality is a social as well as an economic phenomenon and that middle class entitlements have produced an unfocused state.

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What The World Thinks of Capitalism

By way of background, you might be interested in our survey of what the world thinks about capitalism. The seven nation poll carried out by YouGov for the Legatum Institute featured in *The Times* and the *Wall Street Journal*. YouGov investigated attitudes towards capitalism in Britain, Brazil, Germany, India, Indonesia, Thailand and the United States.

The results are summarised on pages 6 and 7. To see the full results visit:
www.prosperity-for-all.com

Tim Montgomerie
Senior Fellow, Legatum Institute

Introduction

Business leaders must be citizens as well as profit-maximisers

"The point is, ladies and gentlemen, that greed—for lack of a better word—is good. Greed is right. Greed works. Greed clarifies, cuts through, and captures the essence of the evolutionary spirit. Greed, in all of its forms—greed for life, for money, for love, knowledge—has marked the upward surge of mankind."

Wall Street, (dir. Oliver Stone) 1987

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Above: *Prosperity for All* was launched by The Rt. Hon. George Osborne, Chancellor of the Exchequer, at the Legatum Institute on 4 November 2015.

This introduction, like the whole report, was written by Tim Montgomerie.

It would have been one thing for the words on the previous page to have been spoken by a famous industrialist as part, perhaps of a great biopic. The director Oliver Stone could have put the fictional words into the mouths of Henry Ford or Thomas Edison, for example. We would have learnt that great inventors and industrialists motivated by the love of ideas and the pursuit of profit—by "greed" for "knowledge" and "greed" for "money"—helped create the past prosperity and past inventions from which we still benefit today. In the spirit of nearly every novelist, poet and film-maker since free enterprise was written about, Stone didn't, of course. As with his other movies, his intention was to subvert. The words he crafted were spoken, therefore, by Gordon Gekko—the villainous character played by Michael Douglas in Stone's classic 1987 movie, *Wall Street*. The Gekko character was allegedly based on Michael Milken, the "junk bond king" who went to jail in 1989 after being convicted on 98 accounts of racketeering and fraud. Sentenced to ten years in prison, Milken only served 22 months—an outcome that could also have been scripted by Stone. As the film ends and just before the credits roll "even when they're caught and convicted… the crooks of capitalism get off lightly" could have appeared on the silver screen.

Gekko's "greed sermon" gets to the heart of the world's love-hate relationship with capitalism. After the collapse of communism in 1989 some kind of version of capitalism—one perhaps characterised by heavy state involvement, as in China, or of the more Anglo-

Saxon, democratic variety—became the only economic show in town. But it is hard to love a system which is based on humankind's sinful traits especially when its proponents appear as crooked as a Gekko or Milken. In *Forging Capitalism: Rogues, Swindlers, Frauds, and the Rise of Modern Finance* (2014), Ian Klaus insists that vice has always been part of capitalism's make-up.

Adam Smith did not talk of greed but he did talk of self-interest. "It is not from the benevolence of the butcher, the brewer, or the baker," he wrote, "that we expect our dinner, but from their regard to their own interest." You can defend self-interest and I would. It is not, for a start, particularly selfish or even selfish at all. It doesn't inevitably lead to criminality—as in the fictional case of Gekko or the real life case of Milken. It can lead to the iPhone, a new malaria-defeating drug or the development of a crop likelier to withstand a drought. Even if it doesn't lead to something as transformational as anything like that, the butcher, baker and brewer—as much as the banker and Silicon Valley entrepreneur—don't just truck for selfish benefit. They truck for their children and wider family, too.

But it all remains inadequate. Uninspiring. Unsatisfying. Compared to the grand promises of heaven on earth from Marxists or even the heart-on-sleeve generosity of philanthropists it's terribly unheroic. We are moral people and without a vision we perish. A system based on accidentally good results is unlikely to produce great loyalty although it is better that self-interest is harnessed for good—as it is in capitalist societies—than it is for ruin—as in communist experiments. Nonetheless, "many people," writes John Plender in *Capitalism: Money, Morals and Markets* (2015), "will continue to feel ill at ease with the paradox whereby capitalism converts vices such as greed and vanity—or, in the more innocuous version, self-interest—into virtue." How can it be, to quote John Maynard Keynes, "that the nastiest motives of the nastiest men somehow or other work for the best results in the best of all possible worlds"? That "nastiness" consisting of—among other things—speculation, massive indebtedness and raw greed.

SO WHAT IS THE ANSWER TO THE QUESTION: WILL PEOPLE EVER LOVE A SYSTEM BUILT ENTIRELY ON SELF-INTEREST? NO. THEY NEVER WILL.

This *Prosperity for All* manifesto doesn't try to neuter "the greed for life, for money, for love, knowledge" that has indeed powered "the upward surge of mankind." Instead it asks for free marketeers to be more than bakers, brewers, butchers and junk bond traders. It asks for them to be citizens too.

It demands that boardroom CEOs don't routinely pay themselves telephone number salary increases. That they maximise the long-term purpose of their firms—rather than their short-term profits. That they accept that the free trade deals of tomorrow will have to include a greater measure of environmental and social responsibility. That they accept that people with economic power cannot buy a similar level of power within the political sphere through donations and lobbying power.

The challenge we need to meet was set out by the founder and CEO of the Whole Foods supermarket chain. John Mackey warned that if the public comes to think businesses are "basically a bunch of psychopaths running around trying to line their own pockets", then the system is in trouble. If the public doesn't think business is fundamentally good, he continued, and can't be trusted to do the right thing business is inviting large-scale and destructive regulation. If, in contrast business exercises responsibilities to all its stakeholders—customers, employees, investors, suppliers, and the larger community—"the impulse to regulate and control would be lessened." For reasons set out throughout this ten part analysis I also think a capitalism of serious citizenship will also be a more successful capitalism. I write as a journalist rather than a politician or economist or businessman. The policy ideas I offer are not ready-to-implement but are largely intended to provoke debate. But before we get into the meat of the analysis I recommend exploring the attitudes to capitalism of the public in seven diverse nations. The results offer food for thought for friends and opponents of the free enterprise system.

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Summary of Global Opinion Poll on Attitudes to "Capitalism", Business and Trends in the World Economy

In order to establish public attitudes to the capitalist system and to some of the questions raised in this report the Legatum Institute commissioned the YouGov polling organisation, headquartered in London, to ask ten questions of populations in seven nations: Britain, the United States of America and Germany (from the developed world), and Brazil, India, Indonesia and Thailand from the faster growing, emerging world. These surveys were conducted in early September 2015. Most answers were received in the days after the turbulence in Chinese equity markets that were popularly described as the "Great Fall of China". The slightly anxious mood of those days might have had some modest effect on the results.

THE BAD NEWS FOR CAPITALISM FROM THE POLLING

There is an almost universal belief that the world's biggest businesses have cheated and polluted their way to success—with barely 10% of respondents in the seven countries surveyed judging that big businesses are 'clean'. Even in America, supposedly the home of free market capitalism, 65% of respondents think the world's biggest businesses have "dodged taxes, damaged the environment or bought special favours from politicians".

Contrary to overwhelming evidence from organisations like the World Bank that global rates of hunger and poverty have been tumbling for approximately three decades, substantial majorities in all seven of the nations in the Legatum Institute poll agree that the poor get poorer and the rich get richer in capitalist economies. 77% of Germans agree that capitalism is a machine for creating inequality—with just 4% disagreeing.

The populations of Britain, Brazil, Germany and America don't think the world is likely to continue to roll forwards. The United States is particularly pessimistic. Just 14% of Americans agree that "the next generation will probably be richer, safer and healthier than the last". More than twice this proportion are optimistic about the future in Thailand and Indonesia. Three times this number are optimistic in India. It's hard to find more conclusive evidence that the American dream is dying in many American hearts and minds.

Majorities of the populations in America, Brazil, India, Thailand and Indonesia support protectionist measures to defend their manufacturing industries from low-cost imports and pluralities support restrictions in Britain and Germany—despite their histories as "open economies".

THE GOOD NEWS FROM THE POLLING

For all of the negativity towards capitalism, more people in all seven nations believe that the free enterprise system is better at lifting people out of poverty than government. This belief is particularly strong in the developing nations we surveyed. In Britain and Germany, for example, there is roughly two-to-one support for believing that "free enterprise" is a superior poverty fighter but in Brazil and India the ratio is a much more emphatic six-to-one.

Although doctors, teachers and charity workers may be more admired than business leaders in many popularity surveys, YouGov found big majorities in all seven surveyed nations for the proposition that "business people and inventors" are just as important to social progress as people associated with what are sometimes referred to as the caring professions.

The populations of India, Indonesia and Thailand are all more optimistic about the future—especially in India, where 50% of respondents expect life for the next generation to be improved. By ratios of fifteen or sixteen-to-one, the people of all seven countries recognise that strong community and family life are as important to wellbeing as strong economies.

The populations of most countries—other than Germany—recognise that government should spend less on welfare benefits in order to fund greater investment in infrastructure. We classify this as good news because the long-term competitiveness of most economies depends upon much greater investment in roads, railways, affordable energy and electronic interconnectivity.

THE OTHER NEWS FROM THE SURVEY

By margins of six or seven-to-one those surveyed recognise that poverty is a bigger problem than inequality and reducing unemployment is a larger problem than cutting the super-rich down to size. The lowest percentage agreeing with the idea that poverty rather than inequality should be policy-makers' focus was Britain but even then the percentage was 61%. India, where hundreds of millions still live in abject need, was, unsurprisingly, most keen for the focus to be on tackling absolute disadvantage and on unemployment. The percentage was 78% to 6% against switching focus to equality.

Only in India is there a majority opinion that business and society's interests are always well matched—most populations, especially in the mature US, German and British nations, recognise that there are often tensions. Again, however, we discover pro-business attitudes are stronger in the less developed quartet of nations we surveyed than the richer trio of our seven.

There is an acceptance in all seven nations that the 2008 financial crash would have been more serious without the bank bailouts. It is notable, however, that opinion is most divided in the US. 35% of Americans think the crash would have been more serious without the bailouts but almost as many (26%) disagree. This +9% gap is much narrower than Britain (where net support for bailouts was +42%), Germany (+30%) and India (+43%).

Go to **www.prosperity-for-all.com** for the full answers to the ten questions in the seven nations.

1

Crash! Bang! Fizzle. The anti-capitalists failed to overthrow free enterprise after the crash but capitalism remains in need of reform

THE $1,000,000,000,000 CHALLENGE

Let's begin by going back to the dramatic events of September 2008 and to some equally dramatic commentary from that time:

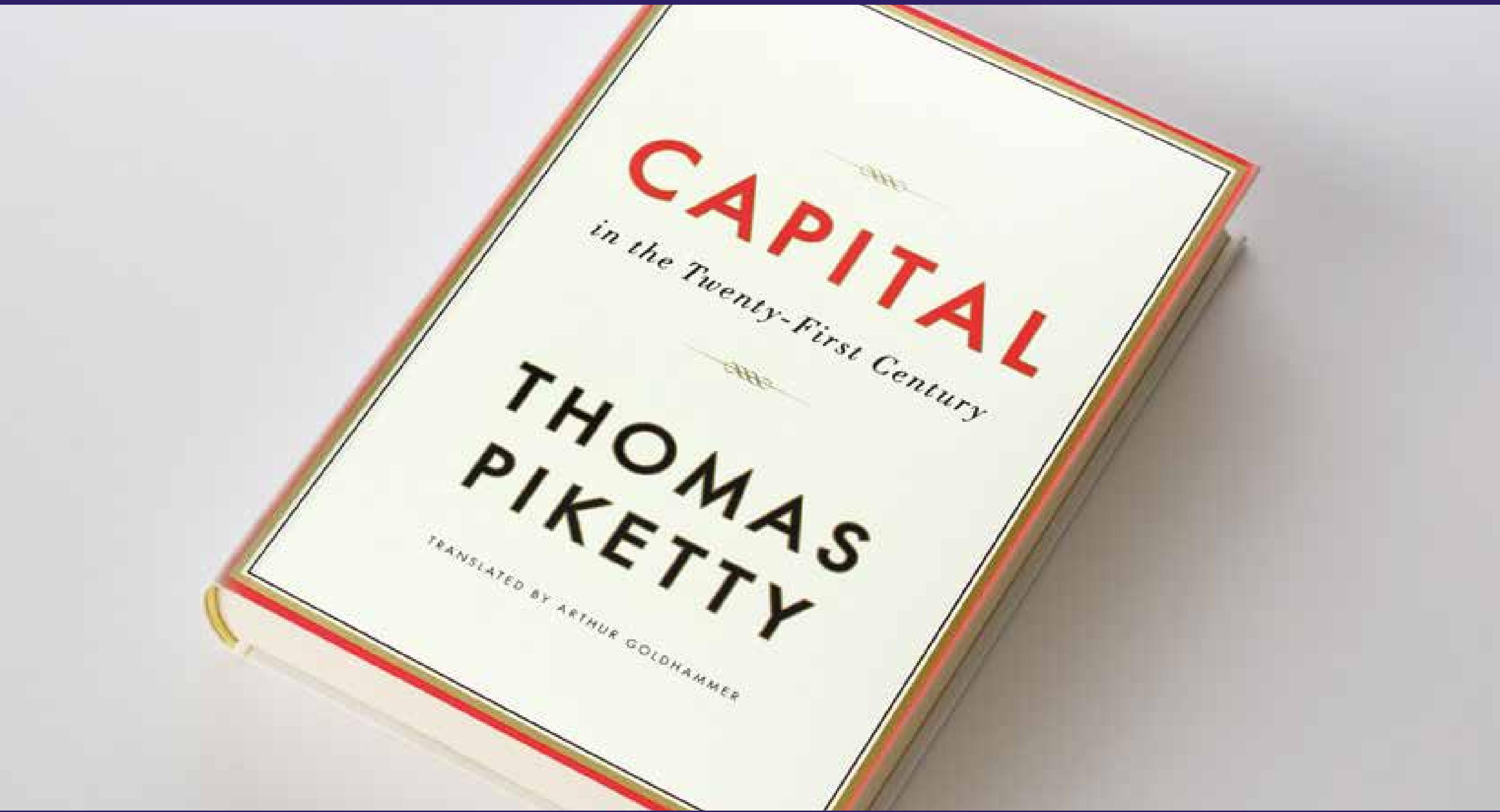
> "The US government has decided it could find $1,000,000,000,000 to bail out rich lenders that had made bad decisions (shareholders have been wiped out, but those that lent too much—one of the errors at the core of the problem—have been saved!). In the future, US taxes will need to service this debt. What argument is anyone going to be able to offer as to why these taxes should be paid by the poor? Higher tax rates for the wealthy in America will represent social justice—otherwise we will be taxing the poor to fund subsidies paid to the rich! Again, who is going to be interested in the future when some fancy Wall Street type sits in a TV studio and criticises subsidies paid out to farmers or car workers? You got paid $1,000,000,000,000 to bail you out! Who are you to complain about a measly few billions to help out someone else? Similarly, wealthy Americans in the future had better pause a moment before complaining about a few paltry dollars given to single mothers or young unemployed boys on benefits. You got paid $1,000,000,000,000 to bail you out! Who are you to complain about money that people use to buy food?
>
> Politics will be profoundly affected by this. It must. More than that. It should.
>
> Another interesting point is how close to the Chinese model the US model has become. State capitalism (i.e. the state providing the capital to fund businesses), as opposed to private capitalism (involving private capitalists), appears to be all the rage."

These words weren't written by an anti-capitalist revolutionary for a far left newspaper. They were written by a free market economist, Andrew Lilico, for the centre-right website, ConservativeHome.com.[1]

We should go back to 2008 because we should recover some of the anger that many of us felt then and also, more importantly, the resolve we felt to ensure things changed. We are all still living with the costs of the bailouts today. Hundreds of millions of people have lost benefits or educational opportunities. Many people have been thrown out of work. Many people who grew rich from reckless financial investments have never been held to account. Some are even prospering again—doing more or less the same thing. While many have-nots suffered many at the top still have-yachts.

For a good period of time class warriors and fiscal hawks were united in their anger. The Tea Party movement gathered around Fox News while the Occupy Wall Street crowd camped in Zucotti Park in Lower Manhattan and by St Paul's Cathedral in London. The two movements may have originated from different corners of the ideological spectrum but both resented the way that big business, and big banks in particular, had been bailed out during the greatest economic shock since the Great Depression of the 1930s. While the Occupy crowd tended to put all of the blame on "rich bankers", and Tea Partiers were readier to blame government for loose monetary policy and incestuous relationships with "big money", there was a wide sense across very different social groups and nations that the existing system of capitalism—or crony capitalism to give it an accurate description—wasn't functioning as it should.

Advanced western societies haven't been engulfed by revolutionary fervour. Electorate after electorate has voted for a steadying of the ship rather than in favour of sailing in a very different direction. It wasn't



Above: Many bought Piketty's *Capital in the Twenty-First Century*, but how many read it?

what friends of capitalism were expecting and they have been breathing a very long sigh of relief since it became obvious that the bark of the anti-capitalist was bigger than their bite.

With the exception of Greece, where Syriza grabbed power in January 2015, the Occupy Wall Street protests did not lead to the election of anti-capitalist governments. There has been an explosion of fringe protest movements, of course—including the United Kingdom Independence Party, the French National Front of Marine Le Pen, Spain's Podemos party and the Donald Trump phenomenon in the United States—but none of these movements have broken through. Not at the time of writing, anyhow.

In reacting to the biggest crisis to engulf the free enterprise system for decades we've learnt that the spirit of the anti-capitalists is willing but their flesh is weak — and also that there simply aren't enough of them. They can't even read the books that they buy. Stephen Hawking's *A Brief History of Time* did have the dubious honour of being the most unread book of recent times but then came

Thomas Piketty; the French economist and unlikely rock-star thinker of the global equality movement. The Occupy Wall Street crowd bought his book, *Capital in the Twenty-First Century*, in large numbers but guesstimates derived from Amazon suggest that the average reader may not have got much past page 26 of the 685-page tome. It became a global bestseller but only 3.8 per cent of the pristine-looking book that sits ostentatiously on the coffee table, next to the latest works of Naomi Klein and Paul Mason, may have actually been read.[2] Premiership football, the new *Game of Thrones* boxset, the *X-Factor* TV franchise or other inventions of free enterprise are too much of a distraction for today's wannabe revolutionaries.

It has never been particularly clear what the anti-capitalists want, of course. Capitalism's critics like to talk about its contradictions but what about their own? Ever since Karl Marx many of capitalism's critics have wanted opposite things. This was understood by Ludvig von Mises in his essential 1972 book, *The Anti-Capitalistic Mentality*. "Critics level two charges against capitalism," he wrote: "First, they say, that the possession of a motor car, a television set and a refrigerator does not make a man happy. Secondly, they add, that there are still people who own none of these gadgets." Donald Sassoon, Emeritus Professor of European History at Queen Mary, University of London, identified many more contradictions in an amusing article for *The Times Literary Supplement* in 2002. Sassoon set out the impossibility of the Left's wish list:

> "Socialism's appeal, when it had one, was to say, at one and the same time, that its mission was to transcend capitalism while improving it; that everyone was equal but that the proletariat was the leading class; that money was the root of all evil but that the workers needed more of it; that capitalism was doomed but that capitalists' profits were as high as ever; that religion was the opium of the people but that Jesus was the first socialist; that the family was a bourgeois conspiracy but that it needed defending from untrammelled industrialisation; that individualism was to be deplored but that capitalist alienation reduced people to undifferentiated atoms; that there was more to politics than voting every few years while demanding universal suffrage; that consumerism beguiles the workers but they should all have a colour television, a car and go on holidays abroad."

Compared to the decade that went before when left-wing governments dominated the developed world the last few years have seen centre-right parties in the ascendancy. Even in America where Barack Obama has twice won the White House, the Republicans have a tighter grip on legislative office—combining the House of Representatives, the Senate, Governors' mansions and state legislatures—than at any time for a century.

But will the reckoning still come?

The series of short articles in this ten part *Prosperity for All* agenda argue that friends of capitalists shouldn't be complacent. They shouldn't be complacent because capitalism remains unpopular in the global court of public opinion. The YouGov findings make that clear. But the second, more substantial reason why they shouldn't be complacent is that free market democracies as currently configured have substantial weaknesses. If we don't act we will end up in the position anticipated by James Brenton in his December 2014 contribution to the Legatum Institute's Charles Street Symposium.[3] Where capitalists don't ensure prosperity is shared and seen to be shared the public will turn against wealth creation. "We risk destroying prosperity," he wrote, "simply because it cannot be satisfactorily shared."

THE UNPOPULARITY OF THE CURRENT ECONOMIC SETTLEMENT

A Pew[4] opinion poll of nearly 50,000 people in 44 countries—conducted in the spring of 2014; a full six years after the global crash struck—found a lot of gloom in developed nations about their economic futures. 50% of Greeks and 51% of Spaniards did not agree that most people are better off under free markets. This might be understandable given those two countries suffered particularly badly within the Eurozone's straightjacket—but an average 65% of respondents in ten leading advanced countries (including Britain, Germany, Japan, South Korea and the United States) expected children to be worse off than their parents—only 28% thought they'd be better off. Those findings are echoed in the YouGov polling conducted for this manifesto and conducted even more recently. Pew found that gloom was particularly pronounced in France where the percentage of pessimists hit 86% but even in America, supposedly the home of free enterprise, 65% expect their children to be worse off and only 30% think they'll be richer. In developing countries, in contrast, 51% expected the next generation to be richer than the last although a sizeable 39% disagreed. You have to go to the "Socialist Republic of Vietnam" to find the country that is most in love with capitalism. 95% of the Vietnamese believe that "most people are better off in a free market economy, even though some people are rich and some are poor". Bangladesh, then China, then Ghana and Nigeria are the next most positive. Sclerotic Europe, according to the Pew research, is the home of pessimism but Japan and the USA aren't so far behind.

CAPITALISM'S SUBSTANTIAL WEAKNESSES

Some of the reasons for capitalism's unpopularity are unfair. Ignorance of its real achievements is often at staggering levels—a subject that is the focus of the next chapter. There is also a lot of ignorance about the role of central banks and poor regulatory policies in producing the events of 2007 and 2008. Reviews of the last few years often miss the contribution that political projects have played in worsening the crisis. The Eurozone, for example, has meant terrible unemployment across much of southern Europe and unnecessarily deep austerity. Outside of the Eurozone Britain and America have enjoyed much faster recoveries. But let's not pretend everything is healthy. This manifesto is a call to action from friends of the free enterprise system—a warning against complacency. More needs to be done to rebut the myths about capitalism but more also needs to be done to correct the real problems in how capitalism is currently practised in the west:

» There is too much insulation of the rich and powerful. If the ladders are in reasonable repair there aren't enough snakes. The poor can get richer but not enough of the rich get poorer when their economic schemes fail. This most manifests itself in the ways in which taxpayers underwrite many large too-big-to-fail banks and other industries deemed to be strategically important.

» There is too little corporate responsibility from businesses infected with Milton Friedman's teachings. There is a focus on short-term profitability rather than the long-term success of the communities in which businesses are located and upon which they ultimately depend.

» There is too little long-term investment—particularly in infrastructure.

» Free trade agreements are being designed by politicians who have the interests of big business rather than of smaller, job-creating businesses and the whole of society uppermost in their minds.

» There is too little protection of the social institutions upon which free market economies depend, notably the family.

» And fundamentally there is too much belief amongst free marketeers in the idea that self-interest and the invisible hand are sufficient for the creation of a good society—a belief that Adam Smith would be horrified by.

THE REAL ENEMIES OF THE FREE MARKET ARE ITS UNCRITICAL DEFENDERS

Four years ago David Cameron promised to confront what he described[5] as the "enemies of enterprise":

> "The bureaucrats in government departments who concoct those ridiculous rules and regulations that make life impossible for small firms. The town hall officials who take forever to make those planning decisions that can be make or break for a business… The public sector procurement managers who think that the answer to everything is a big contract with a big business and who shut out millions of Britain's small and medium sized companies from a massive potential market."

A good trio of opponents of the kind that you would expect a free market politician to identify.

In a recent article for *The Sunday Times* the successful businessman and founder of the Centre for Entrepreneurs, Luke Johnson, was able to identify[6] many more "enemies of enterprise"—listing eight in total. "Socialist politicians" who endlessly intervene in markets were top of Mr Johnson's little list. Then came "unprincipled lawyers" who impose an impossible burden of litigation on businesses. Luddite "union bosses" who use their power to oppose all kinds of technological and workplace modernisations. "Crony capitalists" who succeed in business—not through innovation—but by cosying up to politicians. "Nimby disciples" who would like the property and planning system frozen in time. And "pessimist academics" who ignore all of capitalism's great achievements in favour of doomsday predictions about the environment, austerity and equality.

Luke Johnson's list is a good one because capitalism's conventional enemies may lose battles but they never give up the war. I want to identify one more kind of enemy. They are the apologists within capitalism and within capitalist-friendly parties who will defend anything and everything that is done in the name of economic freedom. That includes massive corporate donations to political parties. Boardroom pay that bears little relationship to underlying performance or international yardsticks. The idea that firms have no responsibilities beyond short-term profit maximisation. That firms have no responsibilities to a domestic country's workforce—only a self-interested interest in large-scale economic immigration. That any kind of sky high interest rate charged by a pay day loan company is ok.

Nearly a century ago John Maynard Keynes recognised this problem. "Devotees of capitalism," he wrote in *The End of Laissez Faire* (1926),[7] "are often unduly conservative, and reject reforms in its technique, which might really strengthen and preserve it, for fear that they may prove to be first steps away from capitalism itself." What we might call a conservative libertarianism is particularly powerful in what we might call the "donor class". This class—that is notable for channelling money to the Republican Party in the USA and to a range of influential global free market organisations—is reflexively anti-government. It benefits disproportionately from low taxes on wealth, high levels of immigration and weak competition policies. It can be as disdainful of the "middle class values" of advanced electorates as anyone on the progressive Left. Ross Douthat, a Catholic writer at the *New York Times*, has repeatedly noted[8] the influence of this class. The challenge for friends of the free market is to work harder to recognise the difference between what free markets do that is in the interests of the largest possible number and what free markets do that narrowly serve the donor class. The interests of the donor class and great mass often overlap but they are not entirely the same. The search to identify the difference is one of the key themes running through this report—not least in a series of new statistical measures that I propose in section four.

2

Capitalism has produced a $600 billion global marketing machine but it has completely failed to sell its enormous achievements

In his 2012 lectures[9] at Gresham College, London, Professor Douglas McWilliams described the last two or three decades as the "greatest ever economic event"—greater in consequence than both the industrial revolution and the "so-called discovery of the Americas". In the 500 years before the discovery of America he noted that world GDP had been increasing by an average of 15% per century (or 0.15% per year). We didn't have Offices for National Statistics in those times so no one can be quite sure!

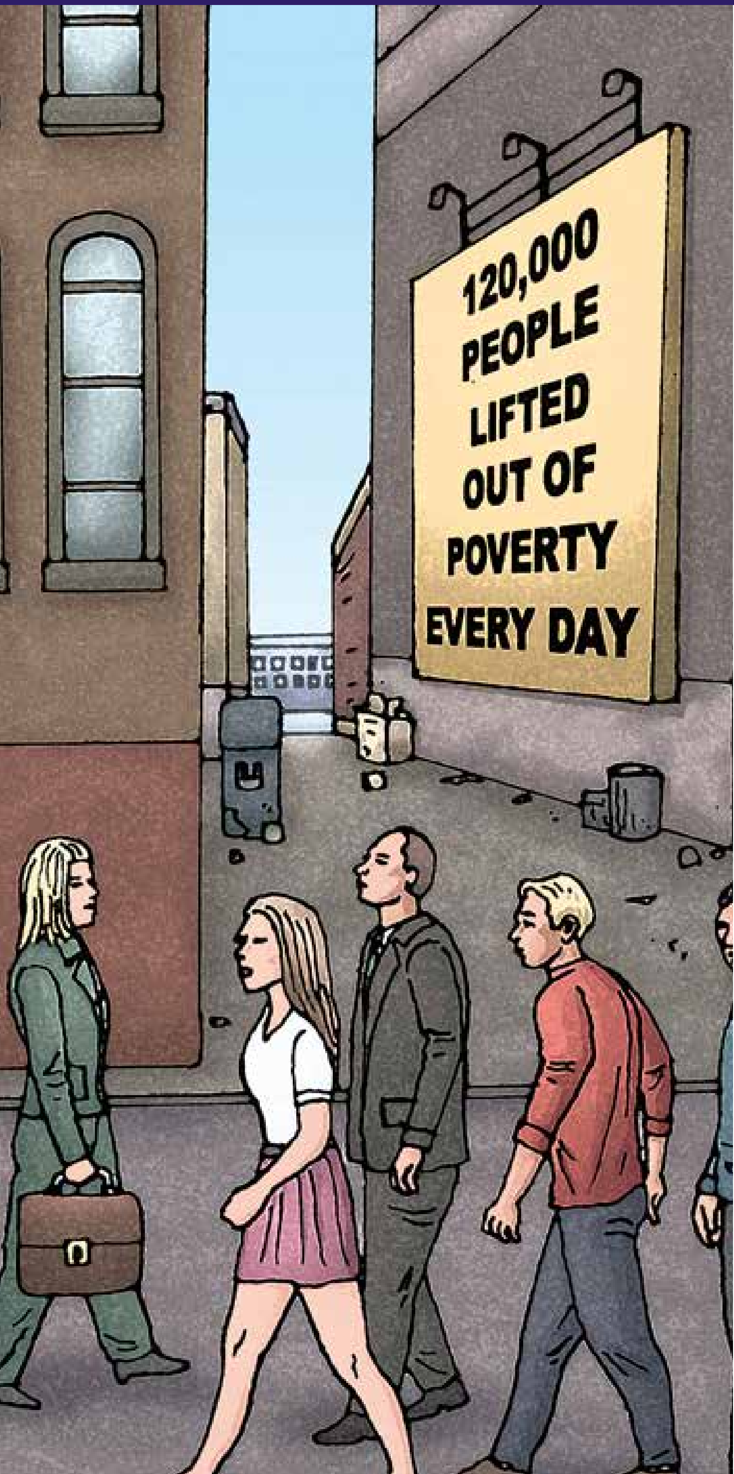
In the century after Columbus' great voyage the rate of growth doubled—to something like 33% per century. GDP per head of population also rose—at about half the speed. Then came the Industrial Revolution: "between 1700 and 1820 world GDP nearly doubled, increasing by 87%. And there was a further increase of 60% in the 50 years between 1820 and 1970." But then, for McWilliams, came the extraordinary events of the last few decades:

> "If we take the more recent period since East Asia other than Japan started to industrialise, from 1970 to 2008 world GDP rose by 270% and world GDP per capita rose by 104%. This is an order of magnitude different from the scale of economic growth after the discovery of the Americas and during the industrial revolution. GDP per capita in China, the most important of the fast growing economies, rose by just under 8 times between 1970 and 2008. Over this period, world GDP rose at an average annual rate of 3.5%."

Capitalism's extraordinary global achievements were recorded in Matt Ridley's 2010 book, *The Rational Optimist*.[10] They are recorded on Twitter[11] on an almost daily basis by Max Roser[12]—a researcher at Nuffield College, Oxford University. At the time of writing, his Twitter feed records the imminence of a polio-free world;[13] the collapse of extreme poverty;[14] the decline of conflict;[15] the steady decline in rates of child labour[16] and the spread of that great fuel for living—electricity.[17]

But guess what? Most people in the developed world have not only missed this great age of progress—they actually think that things are getting worse. They might have spent too much time reading the downbeat speculative fiction of the kind documented by Jane Hu.[18] Perhaps we're too influenced by the endlessly negative advertising of international development charities—and their heart-tugging images of malnourished children? Perhaps the real travails of the developed world economies have caused us to become myopic. Whatever the reason we are hugely ignorant of the world beyond our immediate shores. According to the "Ignorance Survey"[19]—a project of the Gapminder organisation—the populations of developed world countries don't just consistently underestimate the progress that is being made across the globe, they're sure that things are getting worse. For example:

A Gapminder survey in the United States of America found that 66% of people believe that extreme poverty has "almost doubled" over the past twenty years. 29% thought it had stayed more or less the same. Only 5% thought it had almost halved but the 5% are correct. The British people were nearly as inaccurate and downbeat.[20] 58% thought global poverty had increased. 33% thought it had more or less stayed the same. Only 10% correctly thought it had dropped. University-educated Britons were not significantly better informed than the non-university educated. Another survey in Sweden found[21] a more informed population but even in this Scandinavian nation only 23% were correct about the retreat of global poverty. 39% of Swedes thought poverty had doubled and 38% thought that there had been no change. The United Nations notes that "the proportion of people living on less than $1.25 a day fell from 47% in 1990 to 22% in 2010—five years ahead of schedule" (with the schedule set out in the ambitious millennium development goals).[22] And the progress has not just occurred in China—where progress has been particularly spectacular. Extreme poverty has fallen in every single developing world region. There is



The achievements of capitalism are unnoticed.
Illustration by Carla Millar

plenty of work still to do, of course. Although the percentage of under-nourished people fell from 23.2% in 1992 to 14.9% in 2012 that still leaves a humbling 870 million people who are not adequately fed.

People in Germany[23] were asked slightly different questions by Gapminder but similar levels of pessimism—and ignorance—were found. 54% of Germans thought that the number of people dying in natural disasters has "more than doubled". 40% thought the death toll had stayed about the same. Only 6% got the correct answer—that the death toll had decreased to less than half. People consistently underestimate the power of technologies—particularly sophisticated early warning systems—to protect people from Mother Nature. Matthew Kahn, the environmental economist, has found that the deaths caused by an earthquake, for example, fall by 5.3% for every 10% increase in a country's GDP. Interestingly, Kahn could not find any significant correlation between deaths caused by natural disaster and democracy. The rule of law, absence of corruption and regulatory quality were all more important.[24]

THE GREATEST STORY NEVER SOLD

During this year the global advertising industry will spend an estimated $600 billion[25] advertising the products of the free enterprise system to consumers. That's about $90 per person in the key markets of the world. The $500 billion will include $189 billion in America, $73 billion in China, $40 billion in Japan, $28 billion in Germany and $25 billion in Britain. The biggest single advertising sector is personal care with Procter & Gamble Co.,[26] Unilever and L'Oréal the biggest three individual corporate spenders.[27] It is amazing that capitalists as individuals and as corporate entities are so attuned to the need to sell their particular products but so neglectful of the need to sell the free market system as a whole. Next time the great and the good gather at the World Economic Forum in Davos they should consider how they might organise themselves a little better. They could begin by throwing a million or two in Max Roser's direction and his World In Data project.[29] Capitalism doesn't just have a marketing problem—it has more fundamental challenges too—but ignorance of its great achievements is testament to the failings of its supporters and the persistence of its critics.

OTHER HIGHLIGHTS OF THE GAPMINDER SURVEY IN THE USA

- **75%** of those surveyed thought most of the world's population were at the bottom end of the income scale—even though the reality is that most of us are in the middle—living on the equivalent of **$10 per day.**
- **80%** of all adults can read and write but **78%** of those surveyed thought the percentage was much lower.
- **Women aged 25 to 34** have spent an average of seven years in school but 76% guessed that the actual number was more likely just three or five years.
- **Only 17%** correctly told the "Ignorance Survey" that **80%** of the world's population has been vaccinated against measles.

Friends of business organisations like the CBI (formerly the Confederation of British Industry) in Britain need to update the ways in which they operate. Their spokesmen often appear self-serving. They are nearly always arguing for what is best for their members. On the face of it that is fair enough but they might be more likely to succeed in their aims if they were seen to be less self-interested and, instead, backed policies that would create jobs and higher incomes and exports. Put it this way: who are you most likely to listen to on TV and radio programmes? The pinstriped representative of the Roundtable of Amalgamated Corporations or the spokeswoman for the Campaign to End Youth Unemployment? Both could be arguing for the same free enterprise policies but one would undoubtedly be much more potent—especially with swing voters. There's far too little investment from Britain's businesses in think tanks, campaigning organisations and academic positions that promote a business-friendly culture. Why do organisations like London's Reform think tank, the Centre for Policy Studies and the TaxPayers' Alliance have a handful of staff when they should have a hundred? Where, in particular, is the moral campaign for free enterprise? Who talks today as Lord Hailsham talked in 1992?

> "The great advances which have been made in human happiness have been just as much due to the spinning jenny, the internal combustion engine, and the generation of steam as to the moral sublimity of a Shaftesbury, a Florence Nightingale, an Elizabeth Fry, or a Mother Teresa."

THE EIGHT GREAT ACHIEVEMENTS OF FREE ENTERPRISE SOCIETIES

1. Capitalism: A Poverty-Beater

The last few decades have been the greatest economic event in history—as the proportion of the world's population living on less than $1 per day has fallen to just 5%.[29] That's still 5% too many but it's a massive drop.

World Bank data suggested that for most of the last two decades the number of poor people was falling by 120,000 each and every day. The total number of people in absolute poverty dropped by 700 million even as the global population rose by two billion.

The Brookings Institution projects[30] that the percentage living on $1.25 per day (currently 15% of the population) will also be down to 5% by 2030. And why? It's the advance of free markets—including free trade—that has accelerated since the global retreat of Chinese and Soviet socialism but also predated it.

You don't have to take a plutocrat's word for it—or even an analysis from a libertarian or US-headquartered think tank. Will an Irish rock icon do? U2's Bono gave the credit to "entrepreneurial capitalism" in an address at Georgetown University:[31]

> "Rock star preaches capitalism—wow. Sometimes I hear myself and I just cannot believe it. But commerce is real. That's what you're about here. It's real. Aid is just a stop-gap. Commerce, entrepreneurial capitalism takes more people out of poverty than aid—of course, we know that."

And by way of postscript[32] it's not just China: absolute poverty is down from 63% to 37% in Ethiopia; from 32% to 10% in Cambodia; and from 40% to 2% (yes, 2%) in Vietnam.

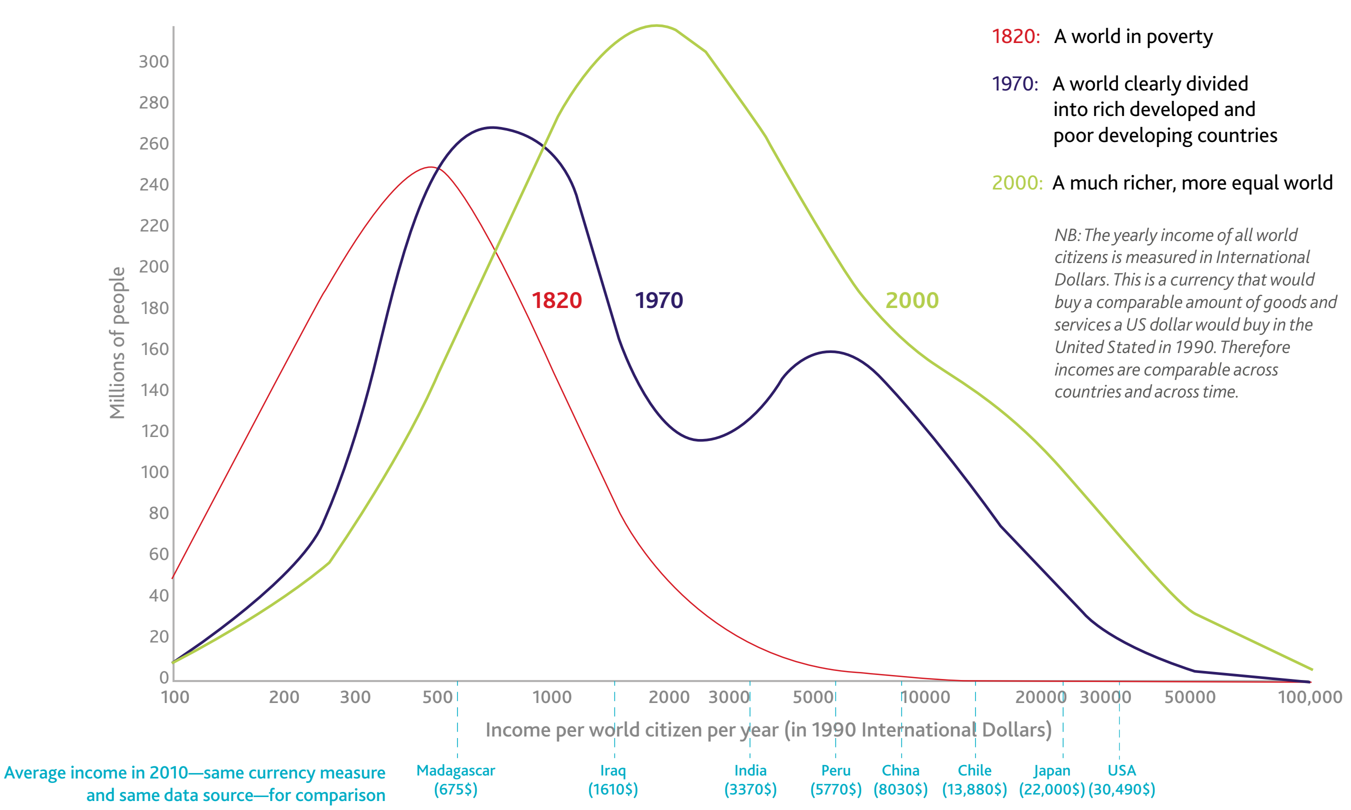
2. Capitalism: A Force for Global Equality

Not only is absolute poverty being conquered we are seeing a lot of progress on global equality too. For all of the real concern about rising inequality within some advanced nations the international picture is encouraging. Although the incomes of the richest 1% are pulling away from the rest of the top 10% (with heavily state-regulated housing markets being one explanation) the biggest gainers are the emerging middle classes in countries like Brazil, China and India.

3. Capitalism: For Health and Happiness

With material progress we have also benefited from a form of super evolution. Life expectancy hasn't just increased dramatically, we have seen diseases of old age pushed back too as a result of healthier eating, sanitation schemes and advances in medical science. "Technophysio evolution" was for the University of Chicago's Robert Fogel,[33] an economic historian and scientist, the biggest story in human history. Taking just one example: "The average adult man in 1850 in America stood about 5 feet 7 inches and weighed about 146 pounds; someone born then was expected to live until about 45. In the 1980s the typical man in his early 30s was about 5 feet 10 inches tall, weighed about 174 pounds and was likely to pass his 75th birthday."

Our wealth is finally helping more and more citizens of the world to realise John Adams' dream, set out in a letter to his wife, Abigail:[34]



"I could fill Volumes with Descriptions of Temples and Palaces, Paintings, Sculptures, Tapestry, Porcelaine, &c. &c. &c—if I could have time. But I could not do this without neglecting my duty… I must study Politicks and War that my sons may have liberty to study Mathematicks and Philosophy. My sons ought to study Mathematicks and Philosophy, Geography, natural History, Naval Architecture, navigation, Commerce and Agriculture, in order to give their Children a right to study Painting, Poetry, Musick, Architecture, Statuary, Tapestry and Porcelaine."

This expansion of opportunity has not just occurred because of the growth in leisure time. Economists at the Deloitte consultancy have studied[35] census results in England and Wales since 1871 and found that technology has not only created more jobs than it has displaced, it has replaced more arduous, muscle-powered jobs with cleaner, safer, more caring and more knowledge-intensive work. It is a trend that is as likely to continue, as stop—despite what modern day Luddites might argue.

Above: The World Income Distribution in 1820, 1970 and 2000. The green line shows that—in modern times—fewer people suffer very low incomes and most people are in the middle.

Source: Max Roser's *World In Data* project. Licensed under CC-BY-SA by the author Max Roser.

4. Capitalism: Equal Opportunity Employer

Capitalism brings people together and it rewards talent regardless of that talent's background, gender, sexuality, nationality, skin colour, age and religion. It's obvious on a football pitch where the leading teams are a great mixture of nationalities, religions and skin colours. The boardrooms—which often have some way to go to become quite so diverse—pay millions for the best strikers, midfielders, defenders and keepers out there. They are blind to someone's background if they can score goals—or stop them from being conceded. The same is true in the dealer rooms of City of London firms. It's a heady mix of Russian mathematicians, Indian computer programmers and market-savvy traders from the poorest parts of London. Voltaire[36] recognised this strength of capitalism many years ago:

> "Enter into the Royal Exchange of London, a place more respectable than many courts, in which deputies from all nations assemble for the advantage of mankind. There the Jew, the Mahometan, and the Christian bargain with one another as if they were of the same religion, and bestow the name of infidel on bankrupts only. There the Presbyterian gives credit to the Anabaptist, and the votary of the establishment accepts the promise of the Quaker. On the separation of these free and pacific assemblies, some visit the synagogue, others repair to the tavern. Here one proceeds to baptize his son in a great tub, in the name of the Father, Son, and Holy Ghost; there another deprives his boy of a small portion of his foreskin, and mutters over the child some Hebrew words which he cannot understand; a third kind hasten to their chapels to wait for the inspiration of the Lord with their hats on; and all are content."

Amen.

5. Capitalism: Peacemaker

The "McPeace theory" hasn't quite stood the test of time. It was the idea that countries which had branches of the McDonald's fast food chain didn't go to war with each other. It was originally suggested by the *New York Times* columnist Thomas Friedman and rested on the idea that McDonald's only established franchises in nations with prosperous, educated middle classes—middle classes that also had the political clout to stop their governments going to war. "People in McDonald's countries," he wrote,[37] "don't like to fight wars; they like to wait in line for burgers". The conflicts between NATO and Yugoslavia in 2000 and then between Russia and Georgia in 2008 challenged the theory. Then, more recently, came the dirty war between Russia and Ukraine—two other "McDonald's countries". Despite the difficulties with the theory it has proved much more true than false.

Through trade we get to know each other. We become mutually dependent. Capitalism is so good at reducing the cost of goods it becomes cheaper to buy them from another country than to fund an army to steal them from it. The McPeace theory is really only a fashionable update of the "capitalist peace" theory that Montesquieu and Adam Smith advanced centuries ago—and which appeared to flounder in World War I.

Nonetheless: there is considerable evidence that free markets are more effective at preventing war than democracy—partly because evidence[38] suggests that poor democracies behave like non-democracies. "If goods don't cross borders, armies will"—is what Frédéric Bastiat is supposed to have said. Let's keep the goods flowing so that protectionist trade wars don't have any opportunity to become actual wars.

6. Capitalism: A Source of Economic Stability

Claiming that free markets are a source of social tranquillity might seem like an over-reach given the awfulness of the Great Depression of the 1930s and the financial crash that began in 2007 and 2008 but as Paul Ormerod has pointed out,[39] those are the only two global crashes of the past 150 years. There have been many ups and downs in financial markets but 70% of all recessions last less than a year. Ormerod also points out that unemployment has averaged 6% to 7% since the 1970s in most advanced nations—not much more than the 3% minimum level of unemployment that John Maynard Keynes said would always exist.

Markets do produce instability because they are characterised by innovation and competition. They also produce instability because they are human—full of people who are greedy. Markets certainly confounded Issac Newton—who as well as a great physicist and mathematician was also Britain's Master of the Royal Mint from 1699 to his death in 1727.[40] Sir Isaac lost the equivalent of $3 million from trading in South Sea Company shares in the 1720s. He was left to ruefully conclude[41] that he could "calculate the motions of the heavenly bodies, but not the madness of people".

So, while capitalism can be unstable, let's never forget that the longest and deepest forms of instability often come from government projects. The creation of long-term youth unemployment across the Mediterranean states of southern Europe—because of the Eurozone and well-intentioned but counter-productive employment legislation—being the latest and most obvious example.

7. Capitalism: A Problem Solver

The greatest reason why dirty ol' coal is increasingly being left in the ground isn't because of global conferences of jet-setting environmentalists. It's technological advance and, most particularly, fracking. This innovative technique has meant that huge quantities of gas and oil can be extracted from shale rock. Although the technique is controversial it did something that no one thought possible: it produced an energy source that was and is cheaper than coal. In the space of ten years coal went[42] from providing more than 50% of the USA's energy to under 40%. It was a way of cutting carbon footprints that, unlike the immature renewable technologies that government attempts to mandate, was and is affordable.

And what about that other spectacularly successful recent innovation: e-cigarettes? Initially opposed by health bureaucrats who didn't like something they weren't in control of, some of those same bureaucrats now want government to subsidise a technology that is doing more to reduce smoking-related illnesses than any recent government prohibition or public health campaign.

The growth of free enterprise isn't just about material growth. It's about the growth of knowledge, science and technology, too. It's about recognising that entrepreneurs are necessary to take a great idea out of a laboratory and on to the high street. "Behind the activities of the businessman," writes Robert W Tracinski,[43] "there is a process of rational inquiry every bit as important as that of the scientist or inventor. The businessman has to figure out how to find and train workers who will produce a quality product; he has to discover how to cut costs to make the product affordable; he has to determine how best to market and distribute his product so that it reaches its potential buyers; and he has to figure out how to finance his venture in a way that will best feed future growth."

You crush entrepreneurialism and you crush that growth, too. Edward Heath understood as much. During the 1970s when the green movement was in its first spring and recommending an end to growth. He was appropriately dismissive:

"The alternative to expansion is not, as some occasionally seem to suppose, an England of quiet market towns linked only by steam trains puffing slowly and peacefully through green meadows. The alternative is slums, dangerous roads, old factories, cramped schools, stunted lives."

Zero growth equals stagnation and the suppression of human creativity. If growth had stopped (as Ernst Schumacher, author of *Small is Beautiful*, had suggested it should in 1973) or stalled (as the 1972 *Club of Rome* suggested it needed to) we wouldn't have the personal computer, the internet or the first vaccine for meningitis. We need more capitalist innovation as the likes of Bill Gates recognise. With the "right environment for innovation" he believes[44] we can develop carbon free energies but innovation rather than the compulsory use of immature technologies is the key. Often—it must be said—with government support. There was public-private collaboration behind George Mitchell's fracking breakthrough in Texas. Government directly and indirectly can be an important partner in innovation. Friends of capitalism may want limited government but they should not advocate a minimalist night-watchman state.

8. Capitalism: Guarantor of Freedom

The free market is more than a mechanism for delivering practical benefits. It is a guarantor of freedom. So long as the church or state or other powerful authority controls the economy people can be limited in where they can travel, what they can read or who they can be. From 1849 to his death in 1883 the capitalist London of Queen Victoria even provided a home to Karl Marx. He wrote his greatest works, including *Capital*, in the Reading Room of the British Library. The communist societies inspired by his dogmas have never been so tolerant of accommodating alternative worldviews.

WHAT'S NEXT?

Let us end this chapter where we began—with Douglas McWilliams. His observation that we have lived through the greatest ever economic change is perhaps not his most important one. More important is his expectation that the changes are to continue for another fifty or so years. There are, after all, still large parts of the world that are barely part of the world economy: notably Africa, most of India's huge population, hundreds of millions of Chinese, and also much of Latin America. Predictions are of course perilous. Edgar R Fiedler's warning that "he who lives by the crystal ball soon learns to eat ground glass" is just one of a long list of humorous jibes at the prophecy business.[45] Nonetheless, McWilliams' basic view that reforms much more ambitious than even those pursued by Margaret Thatcher will be necessary if advanced nations like Britain and America are to stay competitive will frighten many who have unhappy memories of the "Thatcherism" and "Reaganomics" of the 1980s. The sections in this report on social strength, corporate responsibility, middle class entitlement reform, investment in infrastructure and the new nature of free trade agreements point to how we might flourish in the new world economy envisaged by McWilliams.

In the next chapter, however—some thoughts on what Adam Smith would make of the kind of capitalism that is operating 225 years after his death.

3 The dismal state of the dismal science: Adam Smith would not recognise what a morally shrivelled discipline economics has become

"Unchecked market fundamentalism can devour the social capital essential for the long-term dynamism of capitalism itself."

Mark Carney, Govenor of the Bank of England

Which great critic of merchants and manufacturers denounced the "clamour and sophistry", "the impertinent jealousy", "mean rapacity", "mean and malignant expedients", "sneaking arts", "interesting sophistry" and "interested falsehood" of business people who espoused "the vile maxim, 'all for themselves, and nothing for other people'"? Karl Marx? Friedrich Engels? No. It was Adam Smith—as Gertrude Himmelfarb reminded readers of her 2001 essay[46] for *The Public Interest*—"The idea of compassion: The British vs. the French Enlightenment".

One senior policy-maker who is fully aware of the true Adam Smith is the current Governor of the Bank of England, Mark Carney. In remarks on "Inclusive Capitalism" made in May 2014 he said: "To maintain the balance of an inclusive social contract, it is necessary to recognise the importance of values and beliefs in economic life. Economic and political philosophers from Adam Smith (1759) to Hayek (1960) have long recognised that beliefs are part of inherited social capital, which provides the social framework for the free market."

Mr Carney continued:

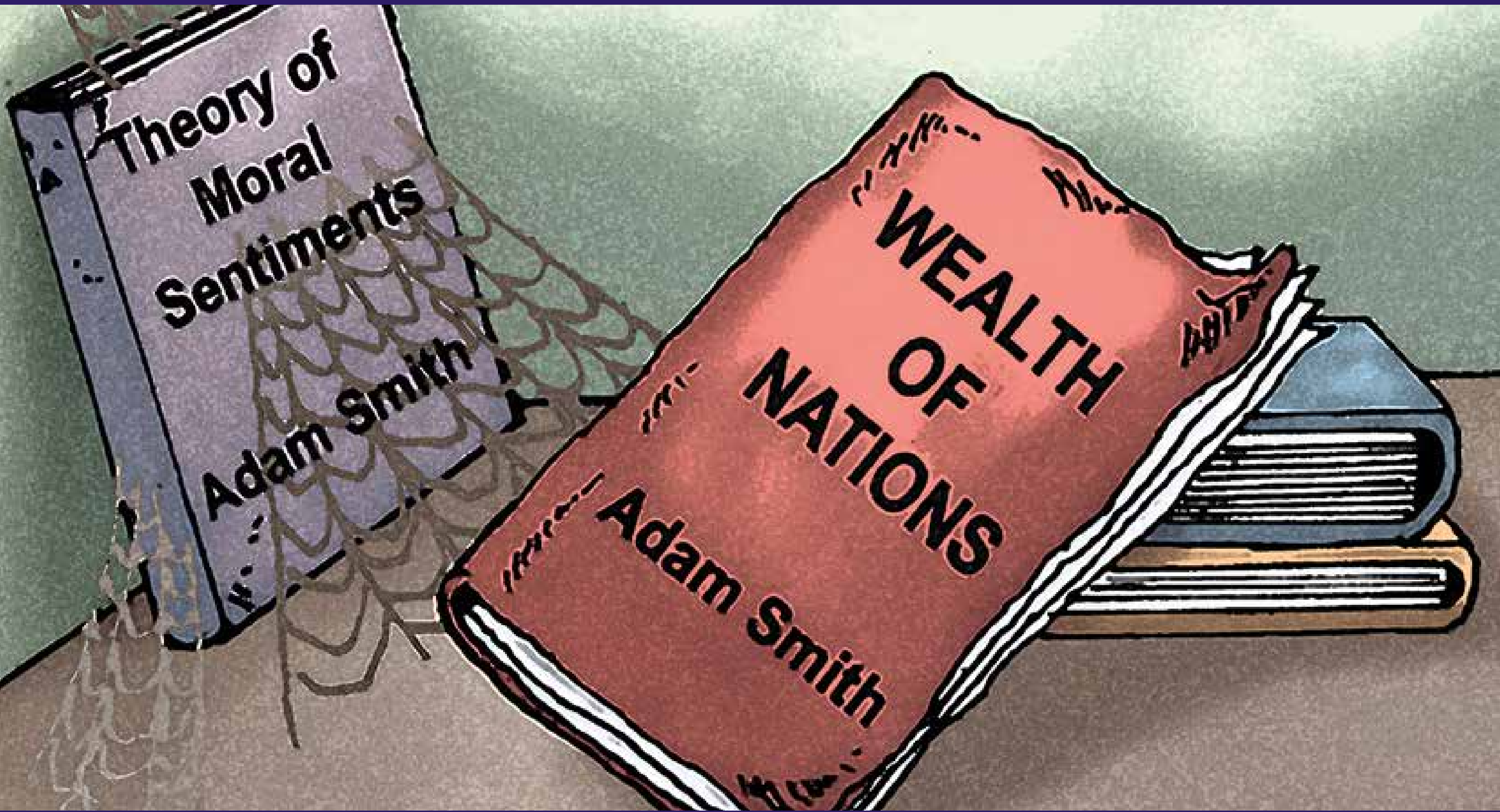
> "Unchecked market fundamentalism can devour the social capital essential for the long-term dynamism of capitalism itself."

"Das Adam Smith problem" was first identified by German philosophers but has occupied many great minds over the more than two centuries since this son of Kirkcaldy and of the Scottish Enlightenment wrote his two great books: *The Theory of Moral Sentiments* (1759) and *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776). Could the ideas of the two books be reconciled or is the Smith of *Theory*—where the subject matter is the moral and social character of people—incompatible with the Smith of *The Wealth of Nations*—where people are allegedly slaves to market forces; led by the invisible hand to do good for others but also, without constraint, will "seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public"?

For Dr Craig Smith, Lecturer in the Scottish Enlightenment at the University of Glasgow and a close student of Smith there is no serious tension. Adam Smith's namesake notes that Adam Smith "assumes a certain social structure before he even talks about the market." Dr Smith continues: "This is the solution to the famous Adam Smith Problem (or non-problem). Nineteenth Century German historians thought that Smith contradicted himself because he stressed "self-interest" in *The Wealth of Nations* and "sympathy" in his *Theory of Moral Sentiments*, but of course the whole point is that the trade in *The Wealth of Nations* takes place and flourishes in a society with the moral relationships described in *Theory*."

What are these "moral relationships"? How do you connect the sympathy for others that Smith introduced in 1759 with the self-interest of 1776? One key to resolution is in appreciating the gulf of difference between self-interest and selfishness. Smith had a very broad definition of self-interest. It contained other-regarding as well as self-regarding dimensions. And "other" in this context is much more than the needs and desires of an individual self's household or immediate neighbours. At the very beginning of *The Theory of Moral Sentiments* Smith wrote:

> "How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortunes of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it... That we often derive sorrow from the sorrows of others, is a matter of fact too obvious to require any instances to prove it."



And while some people are more interested in the happiness and pain of others, Smith was at pains to insist that fellow-feeling was "by no means confined to the virtuous or the humane". "Fellow-feeling" is not exclusively a virtue in Smith's thinking—it is also a natural, instinctive passion. "The greatest ruffian," he wrote, "the most hardened violator of the laws of society, is not altogether without it." Even the fallen animal within us, in other words, as much as the civilised, educated conscience forces all of us at some times and in some situations to be interested in the happiness of others.

It is not the mission of this manifesto to provide a definitive answer to "Das Adam Smith problem". I would, nonethless, recommend Russ Roberts' *How Adam Smith Can Change Your Life* (2014)[47] as containing the pithiest summary of Smith's moral philosophy: "Seek wisdom and virtue. Behave as if an impartial spectator is watching you."

Above: We have neglected Adam Smith's moral core.

Illustration by Carla Millar.

WE NEED TO REDISCOVER THE REAL—MORALLY SERIOUS—ADAM SMITH

My reason for focusing on the perceived intellectual tension between Smith's two great books is not to explore every dimension of it—let alone to resolve it—but to remind all of us of how the man often described as the intellectual godfather of free market philosophy began his work. Smith would hardly recognise contemporary economics: its dry utilitarianism; its endless charts; the econometrics only intelligible to Russian-educated rocket scientists; and the text book conceptions of "homo economicus". I'm not sure he'd recognise a lot of his modern day disciples either—those uber-libertarians always ready to defend every market outcome.

On the website of the admirable Adam Smith Institute there is a list of Smith quotations.[48] Here's one of them, quoted verbatim:

> "Every individual… neither intends to promote the public interest, nor knows how much he is promoting it… he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention."

That is an unfortunate place to stop the quote because Smith's next two sentences are just as interesting. "Nor is it," writes Smith, "always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it." Those extra sentences don't transform the meaning but they certainly qualify it. Society's interests are only promoted "frequently" by the invisible hand. In a University of Oxford discussion paper, published in August 2012, Avner Offer writes:[49]

> "The 'invisible hand' is invoked only once in *The Wealth of Nations*. Its effectiveness is understated: it is merely 'not always the worse for society'; and it does not necessarily promote the interests of society, it only does so 'frequently'. The miraculous powers it has subsequently acquired may not have been intended by its author. In contrast, the 'impartial spectator' (the internalised norm of propriety), is invoked sixty-six times in Smith's first book, *The Theory of Moral Sentiments*, and its authority, the authority of conscience, is taken as binding."

And even if Smith honoured self-interest and respected the invisible hand it was not supreme for him. In *The Theory of Moral Sentiments* he stated that "the wise and virtuous man is at all times willing that his own private interest should be sacrificed to the public interest of his own particular order or society."

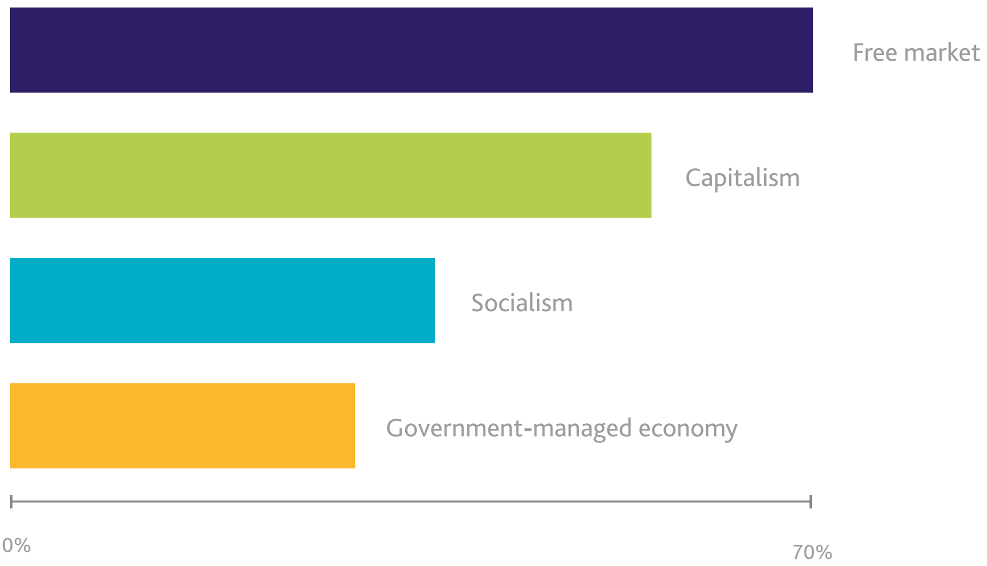
Smith was first and foremost a professor of moral philosophy. His life's work was devoted to a systemic account of men and women as social beings. To explain our social identity Smith expounded two related concepts: "sympathy" and the "spectator". He debated these concepts with the giants[50] of his time: David Hume, Adam Ferguson, Francis Hutcheson and, of course, Edmund Burke.

The relationship with Edmund Burke was particularly important. Burke was interested in the health of the "small platoons" of family, place of worship, neighbourhood charity and voluntary association. "To be attached to the subdivision," wrote Burke in *Reflections on the French Revolution*, "to love the little platoon we belong to in society, is the first principle (the germ as it were) of public affections. It is the first link in the series by which we proceed towards a love to our country, and to mankind." In other words—

The words you use matter

MIND YOUR LANGUAGE

Americans who have a favourable view of:



through the subdivisions or the small platoons—our sense of what Smith would call "sympathy" is developed. Just as Smith's 1759 and 1776 books weren't in great tension, neither were Smith and Burke. Smith[51] is reported to have remarked of Burke that he was "the only man I ever knew who thinks on economic subjects exactly as I do, without any previous communications having passed between us".

In a polemic entitled "Adam Smith, the Last of the Former Virtue Ethicists" Professor Deirdre McCloskey of the University of Illinois at Chicago makes the important observation that Smith did not just want to be a mere bystander, a describer, or, indeed, a spectator. He had moral ideals—or "recommendations" of how things should be ordered:

> "The Impartial Spectator, or the Kantian or even the Benthamite equivalent, are not merely behavioural observations about how people develop ethically. They are recommendations. Recommendations depend on faith and hope and transcendent love, articulated from the identity of an urbane resident of Edinburgh, for example, hopeful for a rather better society, loving sweetly the imagined result. As Fleischacker notes, "When we ask after the

Above: The Reason Rupe Survey

69% of Americans hold a positive view of free markets—more than the 55% who have a positive view of capitalism.

"nature" of human beings we are looking for what human beings "really" want, beneath the surface trappings. . . . Human nature always includes what people aspire to, for Smith; it is never reduced [as in the economist's version of utilitarianism] to the desires they merely happen to have."

FREE MARKETS ARE MORE POPULAR THAN CAPITALISTS

If a true understanding of Smith leads us to restore moral considerations to economics perhaps now is a good time to be sure we know what we're talking about when we talk about "capitalism"? Up until now I've rather loosely switched between talking about capitalism, the free market and private enterprise. Others—the system's critics—increasingly talk of "neoliberalism".

We should perhaps start by noting that "capitalism"—as currently understood—is not a popular term. A Reason-Rupe survey[52] carried out in August 2014 found that 55% of Americans had a favourable idea of capitalism. My guess is that if the poll had been taken a few years before the crash of 2008—rather than a few years afterwards—that number would be higher still. Nonetheless, the Reason-Rupe survey found that capitalism was also much more favoured than socialism (which had a 36% favourable rating) and a "government managed economy" (30% favourable rating). (It is interesting to note—in passing—that socialism appears to communicate an ethical quality that government management does not). But back to the data: beating capitalism by 69% to 55% in the Reason-Rupe survey was the "free market". Only 21% had an unfavourable view of the free market. Nearly twice as many—38%—had an unfavourable view of capitalism.

The Reason-Rupe poll shouldn't just prompt a shift of language. It should prompt a deeper shift of thinking. Away from capitalism and the idea of large businesses, big bank balances and politically well-connected tycoons and towards a free market of competitive, dynamic and customer-orientated businesses.

THE IDEA OF DEMOCRATIC CAPITALISM

In promoting this understanding of the free market I suspect I'll have even most ardent libertarians on side but back to the definitional question again. What is the system we are defending or trying to build? It is a system that works best when it is tamed by strong social and governmental institutions. In his new book, *Postcapitalism*, the Marxist writer Paul Mason describes "neoliberalism"—the chattering class's vogue term of abuse—as a belief in "uncontrolled markets"; a belief that "the state should be small (except for its riot squad and secret police)"; "that the natural state of humankind is to be a bunch of ruthless individuals, competing with each other." I challenged Mr Mason on Twitter to identify one single, senior pro-capitalist politician in power, in the world today who fits his ideological description. Normally ever so engaging he didn't reply to my challenge. John Rentoul of *The Independent* newspaper also tried and failed[53] to get the Channel 4 News economics editor to prove he wasn't Aunt Sallying his opponents. Mason didn't because he couldn't. No centre-right politician who has held high office in recent years is doing what Mason describes—not Angela Merkel, John Key, Tony Abbott, Malcolm Turnbull, Stephen Harper nor David Cameron. No US Republican presidential candidate believes in "neoliberalism". No US Republican governor practices it.

One of the reasons that capitalism will survive is that it's not the caricature Mason presents. Unlike Mason, capitalism's defenders don't have their heads buried in the thinking of dead, Marxist economists. They're pragmatists. George Osborne, for example, the UK Chancellor of the Exchequer, has halved the speed of his deficit reduction policies and introduced a living wage. He's cutting police (and riot squad) budgets so he can expand the British Health Service. He's cutting welfare so he can increase infrastructure spending (a key theme of this manifesto—in chapter eight). And, in another sign that business isn't trusted by George Osborne or the Thatcherite Business Secretary, Sajid Javid, to always do the right thing, there has been the introduction of an apprenticeship levy to compensate for British business' decades-long failure to invest in vocational education.

Libertarians and other advocates of a minimal state play a vital role in politics. The tendencies towards bigger government within democracies are substantial. There are always well-organised interest groups who will make the case for subsidising this or regulating that. Voices constantly warning against the costs of regulation and taxation are essential antibodies. Libertarians cannot be allowed to dominate politics, however. The flexibility of capitalism and of capitalism's defenders defeated the Marxists of yesteryear. It'll defeat Mason's Marxism too but only if capitalism's defenders recognise ideological purity and "homo economicus" do not exist outside of textbooks. The system that is producing the reductions in poverty that we noted in the last chapter is not a pure free market one. Government is involved in reducing inequalities, supporting innovation and infrastructure, and regulating bad practice. The system we are defending might more properly be called democratic capitalism.

Search for "Capitalism" on Amazon.co.uk and up pops a results list to stir every agitator's heart. There's Naomi Klein's *This Changes Everything: Capitalism vs. The Climate*". Michael Moore's DVD *Capitalism*, a story of how the dream of prosperity became a nightmare. And there are also books from Paul Mason, Thomas Piketty, Owen Jones, Ha-Joon Chang and Marxist writer David Harvey—none of them sympathetic. The very top search result, though, is for Arundhati Roy's *Capitalism: A Ghost Story.* It's an extraordinary onslaught on capitalism, America and the impact of free enterprise on Ms Roy's India. Capitalism is blamed for poisoned rivers; the suicide of farmers; punishing debt; intense racism; corrupt politicians; "death squads"; and "obscene inequality". The bombings of Hiroshima and Nagasaki are even presented as just one more illustration of military campaigns "fought to secure "the American way of life"". Even on *The Guardian's* website, now the online home of the international left, the book is described as "an extended rant, strident, intemperate, conspiratorial, and relentlessly one-eyed in its outlook." But it is the top book about capitalism on Amazon and it is not untypical of the relentless cultural attack on the free market system from the ideas-generating cultural classes.

THE TERM CAPITALISM WAS INVENTED BY SOCIALISTS

Capitalism was not a term invented by its adherents. That is well established. But the popular suggestion that Karl Marx was the originator of the term is also wrong. The revolutionary French socialist Pierre-Joseph Proudhon—often known as the "father of anarchism" and best known for his dictum that "property is theft"—was probably the first person to ever use the term. For Proudhon it meant "property-owner".

Dustin Mineau[54] searched the histories of leading US-based free market groups and the capitalist term was nowhere to be found:

> "The Foundation for Economic Education was created in 1946 to promote free markets. And nowhere in their founding 14 principals[55] was the term capitalism. The American Enterprise Institute founded in 1943 didn't defend "capitalism", it defended "competitive, free-enterprise". The Founding article in William Buckley's conservative *National Review* mentions "capitalism" only in relation to socialism. Among the magazine's "convictions", it only states "The competitive price system" and no mention of "capitalism"."

The same is true on the British side of the Atlantic pond. The Institute of Economic Affairs,[56] inspired by Friedrich August von Hayek's *Road to Serfdom* and founded in 1955, described its mission "to improve understanding of the fundamental institutions of a free society by analysing and expounding the role of markets in solving economic and social problems". Again—no mention of "capitalism". Socialists, notes Mineau, had a monopoly on the term "capitalism" for the best part of one hundred years but Milton Friedman never liked monopolies and decided to break this one open in 1964 with his classic work, "Capitalism and Freedom".

As we search for a proper definition of capitalism we should get the basics right and Andrew Lilico does that for us. Writing for *The Daily Telegraph* he argues[57] that "under the (private) capitalist system, those with ideas for businesses but without money to fund them ("entrepreneurs") are free to seek money from those with investment funds available ("capitalists")". In another piece for *CapX* he defines[58] capitalism as only one of three components of "private capitalist markets"—the other two being private property ("a product of being a private person, an individual, a freeman") and markets ("venues of freely chosen exchange; an integral necessity of a politically, religiously and morally liberal society").

I think we need a definition that is broader, however and more in tune with that moral philosophy that Adam Smith would recognise. My colleague at the Legatum Institute, Graeme Leach, is increasingly convinced that values determine the long-term economic health of nations. Having immersed himself in books such as *The Moral Foundations of Economic Behaviour* (2011) by David Rose, *Mass Flourishing* (2013) by Edmund Phelps and *Why Nations Fail* (2012) by Daron Acemoglu and James Robinson he concludes that "honesty, freedom, responsibility, vitality and institutions" underpin sustainable wealth. "Prosperity," he writes,[59] "is built from the ground up, not top down from government… It has to come from the heart and the head of each and every individual." There are people who have taken more ethical—daresay Smithian—approaches to capitalism and society in recent times. I owe much of my political development to the books, pamphlets and dinner table conversations of Lord (Brian) Griffiths, head of Margaret Thatcher's Downing Street Policy Unit. "Monetarism and Morality", "The Creation of Wealth" and his William Wilberforce lecture, delivered to the Conservative Christian Fellowship in 2000 are all essential reads. Wilhelm Röpke's *A Humane Economy: The Social Framework of the Free Marke*t,[60] (1960) and Arthur Seldon's "*Capitalism*" (1990) both had significant moral dimensions but if young economists have time to read only one book I would most recommend Michael Novak's *The Spirit of Democratic Capitalism* [61] (1982).

Marx, argues Michael Novak, was fundamentally wrong about the essence of capitalism. In an address to the Mont Pelerin Society[62] in Sri Lanka in 2004 he said that private ownership, market exchange and the pursuit of profit had existed in the precapitalistic, feudal and aristocratic ages. The new thing about capitalism was enterprise: "the habit of employing human wit to invent new goods and services, and to discover new and better ways to bring them to the broadest possible public." "One sees this," said Novak, "in the very opening of Smith's *An Inquiry into the Nature and Cause of the Wealth of Nations* (1776), in his example of the invention of the machine for mass-producing pins. Such invention is the chief cause of new wealth." Therefore, the cause of the wealth of nations is "caput"—the Latin word for Head or "top" and which forms English words such as captain, decapitate and, yes, capital.

In his *Spirit of Democratic Capitalism* the Templeton Prize-winning Novak doesn't just provide an account of how the economy works. He urged his readers to understand our societies and nations as a product of three separate but overlapping spheres:

- one containing wealth-generating economic markets;
- one encompassing the democratic state and the legal system;
- and, third and most neglected and underestimated, the moral cultural realm.

If any of these spheres becomes too weak or too powerful then democratic capitalism will tend towards to dysfunctionality. The infographic on the right is my attempt at summarising what Michael Novak's analysis should mean for us today.

The four final articles in this *Prosperity for All* manifesto—focusing on middle class welfare entitlements, infrastructure, free trade and financial regulation—might be expected to appear in a manifesto on capitalism written by a free marketeer. But before we get to those subjects the next three chapters take up Michael Novak's conception of democratic capitalism. How do businesses make a bigger social contribution? How can democracy be saved from crony capitalists? And, first, how can policy-makers refocus on the social underpinnings of democratic capitalism?

Free markets, strong democracies and active societies need each other in Michael Novak's vision of democratic capitalism

4

Beyond the market and the state there is society. But because governments measure the wrong things, policy is focused on the wrong things

Margaret Thatcher said a few controversial things in her time. She was reported, for example, as describing the National Union of Miners as the "enemy within"—likening them to other enemies of Britain such as the Argentinian dictator who had invaded the Falkland Islands, General Galtieri. There was the time she snapped at a reporter[63] who had quizzed her about high unemployment. Don't stand there as "moaning minies," she replied: "Now stop it!".[64] Or at the election press conference when she defended her use of private medical care at a time when the State NHS was under pressure. "I insure," she said, "to enable me to go into hospital on the day I want; at the time I want, and with a doctor I want." Many in the public were furious at what they saw as a wealthy Conservative prime minister's lack of empathy.

No Thatcher quote has been more remembered and more misrepresented, however, than something Britain's first female prime minister said during an interview with a women's magazine in 1987. It still haunts her reputation and the Conservative cause to this day:

> "I think we have gone through a period when too many children and people have been given to understand "I have a problem, it is the Government's job to cope with it!" or "I have a problem, I will go and get a grant to cope with it!" "I am homeless, the Government must house me!" and so they are casting their problems on society and who is society? There is no such thing! There are individual men and women and there are families and no government can do anything except through people and people look to themselves first. It is our duty to look after ourselves and then also to help look after our neighbour and life is a reciprocal business…"

We spotlighted another truncated quotation in the last chapter—the truncation of Adam Smith's observation about the invisible hand—but the shortening of this quotation was much more severe and also malevolent. Only a handful of Margaret Thatcher's words are usually quoted—and completely out of context. They've been used to give the impression that she didn't believe in social bonds, only in individualism. If you read the full quote it is clear that the so-called Iron Lady believed very deeply in social responsibility—but of a personal rather than statist kind. For her the command to "love thy neighbour" was addressed to each of us personally and wasn't something we could automatically pass to the state. She didn't oppose state action but it should never be the first resort.

FEED AND FORGET COMPASSION

What Mrs Thatcher objected to was what the American writer Marvin Olasky has described as "stingy compassion":[65]

> A feed-and-forget compassion where we don't love our neighbours ourselves but pay for others to do so. It's one where we don't give our children the time that they need to flourish but instead shower them with toys and use TV and game stations as babysitters. It's where we run schools that award children soft grades rather than ones that build skills that will prepare them for success in life. A feed-and-forget welfare state is one in which we give the unemployed enough money to eat and be housed but not enough care so that they actually become independent people.

PUBLIC POLICY NEEDS TO TAKE A SOCIOLOGICAL TURN

Keith Joseph would have approved of Marvin Olasky's description of true compassion and of Margaret Thatcher's conception of social responsibility. I remember him giving a lecture to Conservative students in which he urged more of them to study sociology rather than economics. If Joseph was Thatcher's guru, Oliver Letwin is the nearest thing to a sage for David Cameron. Like Joseph, Letwin has argued for a sociological turn for Conservatism. In a speech made before the economic crash he gave one of the most thoughtful speeches of the modern political era—and summarised his argument in an article for *The Times*.[67] Here is the key extract:

> "Before Marx, politics was multi-dimensional—constitutional, social, environmental as well as economic. But Marx changed all that. After Marx, socialists defended socialism and free marketeers defended capitalism. For both sides, the centrepiece of the debate was the system of economic management. Politics became econo-centric."

But then, Letwin claimed, the free market triumphed—"from Beijing to Brussels"—and politics "entered a post-Marxist era". "Politics," he continued, "once econo-centric—must now become socio-centric." In the socio-centric era he said the challenge was how to use the prosperity generated by free market economies to make people happier:

> "The mission of the modern Conservative Party could not be clearer. It is to bring about Britain's social revival: to improve the quality of life for everyone in our country, increasing our wellbeing, not just our wealth."

In this new era, he continued, "irresponsible parents" rather than "irresponsible unions" were the cause of weakness. Britain was no longer the sick "man" of Europe but social breakdown made it the continent's sick "family"—characterised by high levels of social atrophy. Social rather than economic decline was the new challenge.

The speech was given in May 2007[68] at a time when Gordon Brown was still boasting about having abolished boom and bust. It was a real "end of history" period when politicians had come to take the creation of wealth for granted. The early signs of the financial crash were beginning to appear but Mr Letwin could be forgiven for not noticing them. New Century Financial Corporation had filed for bankruptcy one month earlier. Up until that moment it had been the second biggest lender to subprime mortgage borrowers in the United States but property prices were now declining sharply. The housing bubble was bursting and the era described by Bank of England Governor Mervyn King as "NICE" (non-inflationary consistently expansionary) was about to end. We were all about to dust off those forgotten books on the 1930s and the Great Depression—especially the Chairman of the US Federal Reserve—Mr Ben Bernanke, a student of the period. We were all about to become a teeny-weeny bit econo-centric again as the whole world was hit by the biggest economic shock of the post-war era.

But if Oliver Letwin's speech was ill-timed and even then a little blasé about the economic challenges facing poorer citizens it was not a fundamentally flawed analysis. Voters at the end of the "NICE" era were increasingly worried about their quality of life, notably environmental issues, as well as their standard of living. The defeat of John Howard in Australia by Kevin Rudd—partly on the climate change issue—was the most obvious political expression of this shift in the priorities of advanced electorates. Justin Trudeau's victory over Stephen Harper in Canada might be a sign that it is about to return again. Letwin wanted the Conservatives to respond to the "quality of life" agenda and he's not the only one who recognises that materialism is not enough.

A NEW KIND OF WELFARE STATE—THAT BUILDS, RATHER THAN ERODES, CONNECTIONS

Alex Smith, a British social entrepreneur and former adviser to ex-Labour leader Ed Miliband, has even argued that a move towards more relational forms of public policy may be more urgent in a period when economic challenges are great. Institutions that traditionally mediated between us and power—like unions, local government and faith communities—are weaker. Banks, the police, the hospital have become bureaucratised—we don't deal with bank managers or local bobbies or matrons but with call centres, robocops in day-glo police cars and wards that jettison us as soon as the medical procedure can be performed. Through online media we often know people in other countries better than we know our next door neighbours. The welfare state, writes Smith,[69] has to be reorientated so that it becomes part of the solution rather than part of the problem. It needs to seek to strengthen relationships rather than replace them. It needs to change from a focus on "making payments" to "making connections". This man of the political Left regards the current welfare state as completely out-of-date:

> "Payments for everyone with children; tax credits which seek to offset, rather than solve poverty; pensions which grow in perpetuity regardless of the recipient's wealth; universal winter allowances for all over-62s (a time of life quite different from the same life stage 70 years ago); housing top-ups which further inflate the market—these are not modern solutions for modern problems."

Smith wants more funding for voluntary groups that build relationships. He wants schools to "re-prioritise personality and character—entrepreneurialism, resilience, disruption, confidence, trust—over traditional qualifications, equanimity and 'hard' skills, if they are to prepare people for the modern world." He wants older citizens "to be brought into schools, colleges and corporate workplaces to provoke, mentor and inspire the next generation—and to help create the mutual community connections that really matter for all, young and old."

"PROSPERITY" IS ABOUT MORE THAN MONEY

The Legatum Institute has long understood that true "prosperity" is about much more than material welfare and our Prosperity Index[70]—an annual rating of 142 nations—is an assessment of eight criteria:

1. Economy;
2. Entrepreneurship & Opportunity;
3. Governance;
4. Education;
5. Health;
6. Safety & Security;
7. Personal Freedom and;
8. Social Capital.

Above: Iain Duncan Smith, Britain's Work and Pensions Secretary, launching the *2015 Legatum Prosperity Index™*

The opinion poll[71] findings mentioned at the start of this report were absolutely conclusive. 79% of Britons think strong family and community life is as important to wellbeing as a strong economy. Just 5% disagree. The conclusion is shared across the world. 81% versus 2% of German people agree. Academics who have studied wellbeing and happiness would not disagree.

THE RELATIONAL UNDERPINNINGS OF HAPPINESS

Terry Leahy, the CEO behind the phenomenal success of the Tesco supermarket group until his retirement in 2011, advised that if businesses focus on profits, they risk failing. If, instead, they focus on looking after customers, the bottom line will take care of itself. C S Lewis said something similar in the context of religious faith: "if you look for truth, you may find comfort in the end; if you look for comfort you will not get either comfort or truth only soft soap and wishful thinking to begin, and in the end, despair". According to Martin Seligman[72]—a self-help guru who roots his advice in scientific research—a similar high-minded focus is necessary for personal happiness. The happiest people don't seek constant pleasure—they seek relationships, meaning and self-understanding. They find time to "do good", in other words. They are often part of religious communities. They go outside. They exercise. They are optimistic. They regularly rest. They regularly detox from social media. In the framework suggested by David Brooks in his *Road to Character* book[73] (2015)—they emphasise eulogy rather than résumé values. They emphasise the things in life that tend to be said of someone at their funeral rather than at a job interview.

"People need social bonds in committed relationships, not simply interactions with strangers, to experience wellbeing". That was the conclusion of Ed Diener and Martin Seligman in their 2004 paper, "Beyond Money: Toward an Economy of Wellbeing". John F Helliwell and Robert D Putnam reached a similar conclusion in their 2005 paper, "The social context of wellbeing":[74]

> "Such evidence as we have suggests that social connections, including marriage, of course, but not limited to that, are among the most robust correlates of subjective wellbeing. People who have close friends and confidants, friendly neighbours and supportive co-workers are less likely to experience sadness, loneliness, low self-esteem and problems with eating and sleeping. Indeed a common finding from research on the correlates of life satisfaction is that subjective wellbeing is best predicted by the breadth and depth of one's social connections."

The Cambridge-based Relationships Foundation suggests that strong relationships will ideally have five qualities:

1. **Directness: relationships need to be face-to-face**
2. **Continuity: there needs to be a regularity of contact**
3. **Multiplexity: honest, effective relationships will be built within more than one setting**
4. **Parity: there will not be unequal power in good relationships**
5. **Commonality: common interests and concerns underpin healthy relationships**

WHAT IS OBVIOUS TO VOTERS AND SOCIOLOGISTS HAS ESCAPED POLICY-MAKERS

Oliver Letwin would say that both the contemporary Right and Left are econo-centric. Another way of describing the problem is to say that both are essentially materialist and individualist philosophies. Both are about providing material goods or services to individual agents. Capitalists on the Right are interested in consumers and workers and investors. Statists on the Left are concerned with taxpayers and public servants and welfare claimants. Where is the political philosophy that puts parents, neighbours and volunteers at its centre?[75]

The family has never been popular with left-wing collectivists. If, in the eyes of conservatives, the strongest families are "social penicillin"—capable of educating, healing and civilising; "the nearest hospital, the first school for the young, the best home for the elderly" to use Pope Francis' words—they do, by the same power, undermine any hope of equality of opportunity. But families aren't just unpopular with many on the Left. The family also perplexes many libertarians. Writing for the Washington-based think tank, the Cato Institute, Lauren K Hall used a recent essay[76] to observe that "it is no accident that John Galt's family was only barely mentioned in *Atlas Shrugged*."[77] The fictional

Galt, who believes in using his own "kaput" for entirely his own self-fulfillment rather than for any social collective, ran away from his family at the age of 12. The family gets in the way of Ayn Rand's vision of individuals who act only out of self-interest and rationality. It also, of course, gets in the way of a mass collectivisation of society which is why it has been unpopular with many radical left-wing movements. "The family's multigenerational bonds," writes Hall, "challenge the demands of immediate collective decision-making and bind us to rules, habits, and ways of life that reject both rationalist and egalitarian reforms." In particular, contends Hall: "the family challenges individualist arguments for personal responsibility and self-sufficiency since it relies in large part on the reality of human need and dependence."

Hall lists thinkers, notably Edmund Burke and Adam Smith, who recognise "the crucial role the family plays in moderating both individualistic and collectivist desires, and thus in ensuring both individual freedom and social stability… the overall point, which needs to be taken more seriously by political theorists broadly, is that the family challenges ideological purity in almost every way."

The other explanation for why relationships are not at the heart of public policy-making may be a straightforward practical issue. It's easier to help someone start a business than keep their family together. Politicians—whose own lives are as complicated as every other person's—are reluctant to look like they are setting up an ideal that they struggle to attain themselves. They fear being accused of preaching or promoting one thing but living another.

I don't think we can afford to be so defeatist. We literally can't afford to be so defeatist. The economic value of strong relational institutions is enormous. We know, for example, that family breakdown costs each UK taxpayer an estimated £1,546 per year (£47 billion in total) according to the Relationships Foundation.[78] The Early Intervention Foundation has estimated that many parents' failure to give their youngsters a healthy diet, read with them regularly or set clear boundaries is resulting in social problems from obesity to criminality that cost taxpayers £17 billion every year.[79] The care provided by the UK's 6.5 million unpaid carers (largely women) would cost £119 billion[80] to purchase if taxpayers had to start footing the bill for looking after sick, disabled or very elderly citizens.

We should know the value of social institutions—what Peter Berger and Richard John Neuhaus called "people-sized institutions" in their 1977 book, *To Empower People: from State to Civil Society*[81]—before we take them for granted and trample upon them. What is the value of a full-time parent, for example, before we incentivise them to go into work? $112,962, according to one very rough estimate?[82] We know the economic value of record levels of UK participation in the labour force. Is there a social cost? Perhaps it's negligible and I should stop worrying. Perhaps it's huge and we should all start fretting.

It does not automatically follow, of course, that just because relational capital matters—that government should do something to protect and enhance it. Government interventions can often cause more harm than good but public policy should be intelligent and informed. Policy-makers should understand what is happening to the nation's social capital and should at least operate by the equivalent of the social Hippocratic oath and do no harm.

At the heart of a relationally serious policy agenda would be more data. David Cameron has experimented with introducing new indicators of happiness since becoming British prime minister but we need much more information on the social solidarity of a nation. If we had that information politicians might worry more about social decline and social growth as much as economic decline and economic growth. The year-long Legatum Institute Commission *Wellbeing and Policy*,[83] chaired by the former head of Britain's civil service, Lord Gus O'Donnell, and including this year's Nobel Prize-winning

Things we should consider measuring—Part 1: What we measure is what policy-makers focus upon

Growth that benefits everyone

For most of the post-war period the relationship between growth in national income and median wages was a steady, proportionate one. It meant that growing GDP also indicated rising median incomes. In recent decades the relationship has broken down with median incomes falling behind GDP growth in some advanced nations. There is evidence to suggest that a lion's share of GDP growth in America is going to the already very rich.

GDP measures that strip out the top 1% and top 10% of households might give a better indication of how the majority of a nation is benefiting (or not benefiting) over time from growth in economic product.

An accurate account of how prices are affecting different social groups

According to the Joseph Rowntree Foundation the bottom 20% of British citizens experienced an average inflation rate of 3.4% during the twelve years up to 2013 – somewhat higher than the 3% that affected the top 20%. Over the period this translated into a 50% price hike for low income Britons, compared to a 43% hike for top income Britons. A similar problem exists in America where rates of inflation have been higher for poor Americans in 139 of the first 168 months of this century (the latest period for which data is available) according to the Federal Reserve.

In announcing the annual increase in the value of social benefits ministers should be required to explain how the chosen level of uprating compares to the level of inflation affecting the group covered by the entitlement.

Fair taxation

When you learn that the highest paid three thousand income taxpayers people contribute more to the Exchequer in income tax than the nine million lowest paid it sounds as though Britain has a very progressive tax system – and it does have a reasonably progressive tax AND benefit system. But the system is a lot less progressive when the burden of other taxes is accounted for. The TaxPayers' Alliance notes that the poorest households paid 47% of their gross income in taxes – a higher percentage than any other group.

Regular publication of tax burden statistics and how they fall on different income groups.

A state focused on long-term prosperity

Nearly all western governments borrow too much but borrowing to establish an early intervention programme to help young people avoid the conveyor belt to crime is a more socially and economically useful expenditure than granting welfare payments to wealthy pensioners. Borrowing to build new badly needed homes for poor families will save money in the long-run, while borrowing to help poor tenants pay private rents will not.

New monthly borrowing statistics should differentiate between projects aiming at reducing the demand for government in the future and those that are not preventative. The challenges of accurately defining investment and spending are huge and different investments will produce very different multiplier effects but there are huge benefits if the efforts are made and the definitions are reviewed and debated.

Things we should consider measuring—Part 2: What we measure is what policy-makers focus upon

The percentage of households wanting more work

A regular measure of underemployment to complement employment data.

There have been suspicions that the jobs created since the recovery began are not of sufficient quality or reward to compensate for the jobs lost in the recession. Those suspicions could be partly put to rest by asking random samples of those in paid work to state how many extra hours they would like to work. It would complement the data already compiled by the UK ONS on part-time and temporary jobs

Differential rates of marriage

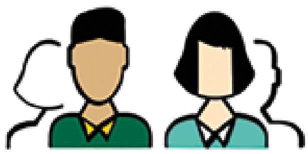
An annual statement of the marriage gap should be published and the politically correct tendency of some statistical agencies to stop collecting marriage data should be curtailed.

Given the socially useful role that happy, stable homes play in raising children, caring for the elderly and binding neighbourhoods together it is alarming that, as Robert Rector of the US Heritage Foundation in Washington DC has documented, America is becoming a two caste society. The children of already rich parents are raised by married parents with a university education while too many poor children are raised by single parents with only a handful of basic qualifications. Fraser Nelson, using research from the Centre for Social Justice, has found a similar division in the UK. Ten years ago those at the top of society were 25% more likely to be married. The percentage difference is now 50%. The four authors of an important extended essay in the Washington Monthly note that "the child of a woman with a bachelor's degree or higher had a less than 10 percent chance of being born out of wedlock. But for the child of a woman with a high school degree or less, the odds of being born to a single mother were greater than 50 percent." We have the emergence of a "two-two-two-one" class: homes with two parents, two college degrees, two incomes and one stable marriage.

Intact families

Regular statements on trends in the number of "LAT" couples.

For understandable reasons the benefits given to couples are lower per capita than to single people. This reflects the economies of scale that couples can enjoy that single people cannot. It does, however, produce perverse incentives for couples to pretend to live apart when they are actually living together – in order to receive more benefits than they are legally entitled to. The phenomenon is called "Living Apart Together". It is not an ideal way to build a stable relationship.



Family-friendly homes

Alongside new housing start statistics the government should publish data on affordability and size.

Australia is a big country and it is perhaps understandable that the average newly-built home is 2,217 square feet in size but other more densely populated European countries are also avoiding what Boris Johnson, Mayor of London, called "homes for hobbits". Compared to the 818 sq ft rabbit hutch homes in Britain, the Dutch manage 1, 249, the Belgians 1,281 and the Danish 1,475. The hutches are getting smaller, too. London Residential Research says the average one-bed flat has shrunk in size by 13% since 2000.

economist Angus Deaton, reported last year. As well as emphasising new internationally-comparable statistical measures of the quality of life it spotlighted the fact that only one in four citizens of advanced countries affected by mental illness were in any form of treatment. It also set out a range of practical ways to help parents enjoy healthier, happier relationships and also set out an agenda for building character in schools, a theme taken up by Sir Anthony Seldon in his February 2015 lecture to the Legatum Institute: "Character and Values in Society and Education".[84]

In the meantime a major housebuilding and community infrastructure programme might provide the best single policy for helping keep families and communities together. In "Holding The Centre: Social Stability and Social Capital"[85]—a policy paper produced by four British Conservative MPs: Fiona Bruce, Jeremy Lefroy, John Glen and Caroline Spelman in September 2014—there were recommendations for longer term contracts for private renters, housing developments to include more homes designed for flexible use and new ways of capturing "planning gain" to increase investment in infrastructure and affordable housing. If we want family life to flourish the current expense of housing and the indebtedness it causes, the insecurity of tenure and the cramped nature of "rabbit hutch" developments are all problems. Consideration should be given to eliminating "marriage penalties" in the welfare system and also the kind of parenting classes recommended by Steve Hilton,[86] David Cameron's former strategy adviser, but giving every family a good home is probably the best single pro-family policy.

POSTSCRIPT: ARE RELATIONSHIPS MORE IMPORTANT THAN ECONOMIC GROWTH?

Diener and Seligman even argue that the quality of relationships matters more than a person's economic standard of living: "Although economic output has risen steeply over the past decades, there has been no rise in life satisfaction during this period, and there has been a substantial increase in depression and distrust. We argue that economic indicators were extremely important in the early stages of economic development, when the fulfilment of basic needs was the main issue. As societies grow wealthy, however, differences in wellbeing are less frequently due to income, and are more frequently due to factors such as social relationships and enjoyment at work." For the reasons set out in chapter two, economic growth delivers so many medical and social innovations that it would be very dangerous to pursue an anti-growth policy but Diener and Seligman's research should point us to the danger of any economic advances that hurt social solidarity.

5

Short-term profit maximisation does not produce enduring success. The most successful businesses maximise long-term "purpose"

"Don't go into corporate America. Become teachers. Work for the community. Be social workers. Be a nurse. Those are the careers that we need and we're encouraging our young people to do that. Make that choice, as we did, to move out of the money-making industry into the helping industry.
...Because other than creating jobs, innovating, paying the taxes that public services depend upon and helping to reduce poverty across the world—business never helps anyone. Michelle Obama

So said Michelle Obama in 2008—shortly before she became her country's First Lady. Fortunately most Americans don't necessarily agree with her. 69% of Americans agree that "successful business people and inventors are just as important to society as doctors, teachers and charity workers" (from the YouGov global poll for the Legatum Institute)[87]. But even if people think business leaders are important to society they do not necessarily admire them on a more personal level. Most business folk joined Members of Parliament and journalists near the bottom of YouGov's annual survey of Britain's professions. Conducted at the end of last year, the pollster found that just a quarter trust the managers of big businesses whereas 81% of Britons trust teachers and 89% trust nurses. And it's not just bankers that are dragging all of the commercial sector down. Only 30% trust entrepreneurs and even small businesses couldn't break above the 50% trust ceiling.

A survey by the UK-based Institute of Directors (IoD) found that a plurality of business leaders recognise that these public attitudes are a problem. 48% of respondents to the IoD survey said[88] that a lack of public trust in business was a quite (30%) or very (18%) important threat to the success of their business. 26% thought public trust in business was either not very important (16%) or not at all important (10%). We know from the YouGov survey[89] that 64% of Americans—in tune with people in the other six nations that we surveyed—think that most businesses have dodged taxes, damaged the environment or bought special favours from politicians in order to flourish.

Businesses have, of course, been portrayed negatively by much of the press and in much popular entertainment for a very long time but they also face a more fundamental public relations challenge. The positive benefits that they provide for the whole of society—including jobs, good value products, and the tax revenues upon which public services depend—are often seen as by-products of the pursuit of profit. We tend to most admire people who do things for selfless rather than self-interested reasons. Florence Nightingales rather than Henry Fords. Mother Teresas more than James Dysons. This is frustrating on many levels as it is undoubtedly true that the social benefits of self-interested business behaviour are many times greater than the fruits of selfless charitable behaviour. I'd offer the impact of foreign direct investment in developing countries versus the impact of overseas aid spending as my Exhibit A. As U2's Bono has noted. Technological innovation delivered by business—such as mobile phone technology—has been much more important for African economic growth than any individual NGO; however big-hearted that NGO might be.

But if businesses want a different kind of reputation then it is clear that doing the same things that they've always done—however spectacular they might be in terms of the benefits they produce—isn't going to be enough. Businesses need to do different things to achieve a different status in society. Let's look at two business leaders who have chosen a different mode of operating.

JOHN MACKEY OF WHOLE FOODS: REJECTING PROFIT MAXIMISATION FOR PURPOSE MAXIMISATION

One business leader who gets this is John Mackey. Mackey co-founded Safer Way Natural Foods in Austin, Texas in 1978—a supermarket specialising in organic, healthy and natural food. Whole Foods Markets, as it has been called since 1980, now has more than 400 stores (including a handful in Britain and Canada), employs nearly 60,000 people and has a market capitalisation of approximately $20 billion. But this very successful businessman is hard to pigeon-hole. He's a vegan. His stores are the choice of well-heeled, environmentally-conscious liberals across America. But this "cool capitalist" is also a trenchant critic of Obamacare and labour unions.[90] He opposes the minimum wage—saying that if someone wants to work for $10 an hour and an employer is willing to pay that $10 then government has no business insisting that $15 or any other greater sum is paid. Milton Friedman is one of Mackey's intellectual heroes but he does not follow Friedman slavishly. Most importantly Mackey rejects what has become known as the "Friedman doctrine". In his 1962 book, *Capitalism and Freedom*, the Nobel Prize-winning economist wrote:

> "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, engages in open and free competition without deception or fraud."

Only people—not corporations—have responsibilities, wrote Friedman[91] in a 1970 article for the *New York Times* magazine. Friedman likened the doctrine of "social responsibility" to socialism, arguing that if a company's profits were to be used for charitable or other social goods then that good should be executed by shareholders as private citizens—financed by their dividends—rather than by the corporation.

He accepted that individual proprietors could quite legitimately "reduce the returns of his enterprise in order to exercise his "social responsibility,"" [because] he is spending his own money, not someone else's." This might impose higher costs on customers and less remuneration for employees but Friedman could see benefits from such behaviour:

> "It may well be in the long run interest of a corporation that is a major employer in a small community to devote resources to providing amenities to that community or to improving its government. That may make it easier to attract desirable employees, it may reduce the wage bill or lessen losses from pilferage and sabotage or have other worthwhile effects. Or it may be that, given the laws about the deductibility of corporate charitable contributions, the stockholders can contribute more to charities they favour by having the corporation make the gift than by doing it themselves, since they can in that way contribute an amount that would otherwise have been paid as corporate taxes."

Crucial for Friedman, however, even in these actions is that it is in the self-interest of the corporation to generate goodwill—it is not "social responsibility".

Mackey, in contrast, believes that a business only obsessed with making a profit contributes to the creation of an anti-business environment. Speaking to the libertarian website reason.com he argued[92] that the anti-capitalist Left is empowered if the public comes to think businesses are "basically a bunch of psychopaths running around trying to line their own pockets". If the public doesn't think business is fundamentally good, he continued, and "we can't trust them to do the right thing, so we're going to have to do it for them." If, in contrast "business has these responsibilities to all its stakeholders, its customers, employees, investors, suppliers, and the larger community, if business behaved like that, the impulse to regulate and control would be lessened."

Mackey thinks a new post-Friedman generation of capitalists is now emerging. Employing the rather macabre expression that "social progress is made one funeral at a time" he argues that while the more elderly professors at business schools are still slaves to the idea of "shareholder value", MBA students are "lapping it up"—"it" being the ideas contained in the book he wrote with Raj Sisodia; *Conscious Capitalism*.

In *Conscious Capitalism: Liberating the Heroic Spirit of Business* (2013)[93] Mackey makes two principal criticisms of business: (1) that there's too much profit maximisation rather than "purpose maximisation"; and (2) where Friedman would be in agreement, business is too focused on building cosy relations with government "that may not result in the greatest common good." Mackey is a critic of the "too big to fail" model that operates in large parts of what he calls America's system of "crony capitalism". He recommends four key principles for "conscious capitalism"—a capitalism where business owners are conscious of how their decisions affect the business environment in which, in the long-term, they either thrive or flounder:

a. **A higher purpose:**[94] "For Southwest Airlines,[95] it is giving more people the ability to see the world. For Google,[96] it is organizing the world's information and making it universally accessible. For Whole Foods[97] it is helping people enrich their lives through healthier food choices." Mark Carney has called on this idea to be central to all banks and financial institutions: "Financiers, like all of us, need to avoid compartmentalisation—the division of our lives into different realms, each with its own set of rules. Home is distinct from work; ethics from law; the individual from the system. This process begins with boards and senior management defining clearly the purpose of their organisations and promoting a culture of ethical business throughout them. Employees must be grounded in strong connections to their clients and their communities." Mr Carney was thinking of avoiding the attitude described by the CEO of TD Bank, Ed Clark. In 2012 Clark observed: "Bank leaders created cultures around a simple principle: if it's legal and others are doing it, we should do it too if it makes money. It didn't matter if it was the right thing to do for the customer, community or country." Justin Welby, the Archbishop of Canterbury, believes that high social goals can and should be embedded in a corporation's DNA. Focusing on the UK context, he promotes the idea of "gratuity"[98]—citing the Post Office which is "required to maintain branches in one form or another in areas which will never be profitable"; the telephone system which ensures "there are landlines for remote communities in rural areas where the revenues will never return the capital invested" and "railways run with an element of the public good"—including discounted travel concessions for certain social groups. These forms of gratuity tend to be statutorily imposed but there is no reason why the banking sector, for example, couldn't choose to provide a basic banking account for all citizens (with no opportunity to go overdrawn). As noted in chapter seven, the cost of having to use non-mainstream financial services adds up to tens of thousands of dollars over a lifetime for very poor households. A decision by the banks to collectively undertake such a social role could transform their public standing.

b. Stakeholder integration: "Without employees, customers, suppliers, funders, supportive communities and a life-sustaining ecosystem, there is no business" says the website of *Conscious Capitalism*.[99] The idea that everyone is joined together in tangible ways is most exemplified by the company's pay policy: no one at the top of the business can earn more than 19 times those at the bottom.

c. **Conscious leadership:** A management culture that brings out the best in all members of the business organisation—inspiring innovation and service rather than micro-managing. Mackey tells a story of an employee who decided to give $40,000 of produce away after the cash registers all failed for thirty minutes—during a raging snowstorm. He concluded that the goodwill generated couldn't have been bought with $40,000 worth of advertising.

d. **Conscious culture:** "Culture eats strategy for lunch," said Peter Drucker and Mackey agrees. This aim sounds very similar to aim (a) to me but Mackey would probably note that it is not enough to have the purpose articulated above—every stakeholder in an organisation must also understand

> that mission and feel able to contribute to it. Mackey is certainly sure of the "Whole Foods" mission and has written: "Most of the diseases that kill us and account for about 70% of all health-care spending—heart disease, cancer, stroke, diabetes and obesity—are mostly preventable through proper diet, exercise, not smoking, minimal alcohol consumption and other healthy lifestyle choices. Recent scientific and medical evidence shows that a diet consisting of foods that are plant-based, nutrient dense and low-fat will help prevent and often reverse most degenerative diseases that kill us and are expensive to treat. We should be able to live largely disease-free lives until we are well into our 90s and even past 100 years of age."

Putting your head above the parapet—as Mackey has done—invites extra scrutiny. He has been accused of "corporate fascism" for some of Whole Food's activities. Moreover competition from Trader Joe's—another supermarket appealing to ethically-conscious shoppers—has tested his commitment to his values. Overall, however, he has won the admiration of his peers in the business world—despite his unconventional focus on purpose maximisation. Luke Johnson of the Centre for Entrepreneurs is one such admirer:

> "Mr Mackey is willing to stand up and celebrate the achievements of free enterprise and make the case for entrepreneurs to be seen as modern heroes. He is credible because his company is cool but highly profitable. He argues convincingly against creeping government regulation and the demonisation of capitalism."[100]

BILL GATES OF MICROSOFT: MORE POPULAR THAN BARACK OBAMA, THE POPE AND LIONEL MESSI

If we are looking for someone who has won widespread admiration across social groups and across the world we need look no further than Bill Gates. For two years in succession a YouGov/*The Times* survey of 25,000 people in 23 nations has found that the world's most admired person isn't Pope Francis, Barack Obama or Cristiano Ronaldo. It's the founder of Microsoft.[101]

With his wife, Melinda, Mr Gates is also one of the world's biggest philanthropists—successfully fighting malaria and other deadly diseases all over the planet. With other super-rich individuals he has signed The Giving Pledge[102] and will by the end of his lifetime, or in his will, donate at least half of his worldly wealth to good causes. It's the combination of material success and beyond-the-bottom-line generosity that we appear to admire. In Britain, Lord Ashcroft's support for military veterans has earnt him many plaudits. We warm to Richard Branson because of his support for great causes and, of course, for his daredevil pursuits, too. The Cadbury and Rowntree family names live on in public affection because of the charitable projects that they endowed. To be popular all of these people and businesses have acted—to use that expression again—"beyond-the-bottom-line". It doesn't have to mean philanthropy. Today it might mean paying more than the statutory minimum wage to employees—ideally even the Living Wage—and taking a more market-based approach to directors' remuneration packages. It could be gold-plating apprenticeship programmes—rather than simply meeting the government minimum standards for training youngsters. It might mean not sponsoring the murky world of Fifa but investing in University Technology Colleges instead.

It might not seem necessary for businesses to worry about their opinion poll ratings. Perhaps that should be left to the politicians? But it's the politicians and their focus on opinion polls that should worry businesses. The capitalist-sceptic Left might not remain unpopular in Britain—or in other advanced

economies. There are circumstances in which it and its agenda could return to power. It is also true that the Conservative or Republican parties might play to the populist gallery if they thought some anti-business policies could win them votes in a tight election. Defending the City of London or Wall Street, in particular, is unpopular across the political spectrum. You don't have to be a tobacco company to be unpopular anymore—just ask supermarkets or energy companies.

So long as there is a shortage of respected CEOs or entrepreneurs in the public sphere—who are able to compellingly defend business—there's always a danger that anti-business policies might be implemented. Time is currently on business' side given the nature of the governments that have been winning elections since the global crash. Even Michelle Obama hasn't repeated anything as silly as her 2008 remarks about "money-making" since her husband entered the Oval Office. Every business needs to use this safe time wisely and focus on what kind of beyond-the-bottom-line projects it can pursue. All with the aim of ensuring nations like Britain and America remain places where it's good to be in business.

Above: Bill Gates

POSTSCRIPT: MINDING THE GAP

There is probably no area where corporate responsibility is more needed than the area of executive pay. It is not just people on the Left who recognise that the current system leaves something to be desired. Mark Field, the Conservative MP who represents the constituency that includes London's Square Mile of major banks and financial companies, admitted[103] that a few years ago he could not imagine that he would have been "open minded to the notion of government interference in the remuneration of privately owned companies". But, writing three years ago, he set out the kind of interventions he was now open to making. They included "tackling handsome dismissal packages for ineffective executives, commencing with equitable clawback schemes for unwarranted rewards (Sir Fred Goodwin's pension springs to mind) and making shareholders—particularly large, institutional shareholders who must be more than just absentee landlords—more effective in insisting that earnings reflect reality."

Mr Field was not alone. Mark Carney, the Canadian Governor of the Bank of England, has stated that "we need to recognise the tension between pure free market capitalism, which reinforces the primacy of the individual at the expense of the system, and social capital which requires from individuals a broader sense of responsibility for the system."

Boris Johnson, Mayor of London, has worried aloud[104] about the rise and rise of chief executive pay:

> "How high do they tower, these great corporate sequoias, over the tiny shrublets of humanity? How high do the gullivers of capitalism loom over the lilliputians—I don't mean to single out Stuart Gulliver. The answer is not 50 times, not 60, not 100 but 130 times…That is the average multiple of earnings …It has probably more than quadrupled in the last forty years."

Many business leaders are "getting it" too. More than half of directors of the IoD[105] admit that anger at executive pay was a threat to the status of business in society. Only 28% thought the public's unrealistic expectations were a greater threat. The leadership of the IoD has also been willing to criticise pay deals.[106]

The evidence within the United Kingdom is that top pay is beginning to moderate. Adjusted for inflation the average pay of chief executives fell in the last year.[107] Top pay is actually down by 4.9%[108] (in real terms) since 2010. Few people will feel sorry for this squeeze on top pay, of course, and nor should they. This small reduction starts from a very high base. Pay rises more rapidly in the good years than it moderates in the leaner years. City bonuses, for example, tripled between 2002/03 and 2007/08: rising from £3.3 billion to £11.6 billion. There has never been a proper reckoning since. Bonuses equalled £15 billion in 2014.[109] CEO remuneration and the average remuneration of those at the top of FTSE-100 companies (£4.964 million in 2014—nearly £100,000 per week) is still at a 183:1 ratio in comparison to the average remuneration of the full-time workers of that CEO (a median wage of £27,195). The ratio was 50:1 at the start of the millennium and just 20:1 in the 1970s. The current ratio in America is 373:1 with the average CEO earning $13.5 million.[110] At Wal-Mart it is 537-to-1. Some "friends of capitalism" will defend this position as they will defend any and every market outcome. But it's too simplistic to say that these awards are the product of a free market. In many European nations the ratio between average pay and boardroom pay is more like 100-to-1 and in some countries it is a lot lower than that. National cultures, tax systems and corporate governance regimes are clearly playing a part too.

There are many examples of good CEOs making a difference. Kate Andrews of the Adam Smith Institute has argued that bad leadership at Kodak meant the once all conquering photographic film company never invested in digital cameras. The result was bankruptcy. In contrast Steve Jobs' return to Apple was the moment a failing company in the global computing business started to become the powerhouse that it is today. What worries many, however, is that overall pay awards bear little relationship to company performance. The High Pay Centre analysed pay data and key company performance metrics between 2000 and 2013 and found that the median earnings of a FTSE 350 Company Director increased more than twice as fast as median pre-tax profits at FTSE 350 companies and four times as fast as their median market value. FTSE 350 Directors' pay[111] grew nearly twice as fast as pay for all full-time UK workers.

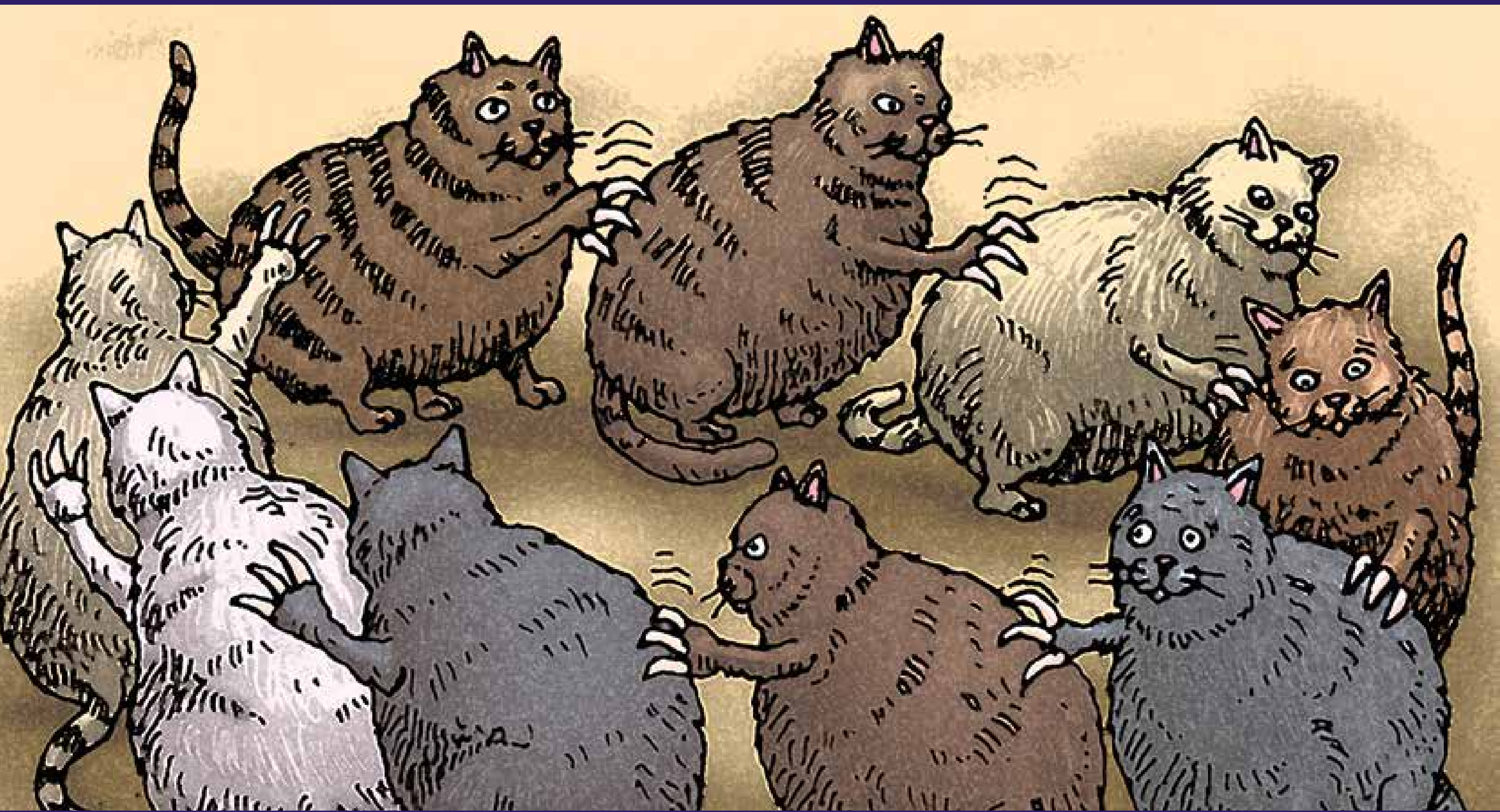
Another myth busted by the High Pay Centre is the idea that there is a global market in CEOs. A 2013 report from the Centre—*Global CEO Appointments: A Very Domestic Issue*[112]—found that 80% of CEO appointments in the world's largest 500 companies are internal promotions. Only 0.8% of CEOs were poached from another CEO position in another country. 6.5% of CEOs were poached from another company, while serving as a CEO. While comparisons with the football transfer market are often made there simply isn't the same international market in CEOs. Another difference between football and corporate boardrooms was pointed out by the former Business Secretary Vince Cable.[113] Just because Manchester United's Wayne Rooney wins tournaments that doesn't justify everyone getting Wayne Rooney's wages. "And," insisted Cable, "it is not a committee of Manchester United players who set the pay of Wayne Rooney".

Clare Foges, David Cameron's former speechwriter and not, therefore, known for her revolutionary politics, has recommended worker representation on boards. Noting that the average annual pay of remuneration committee members is a substantial £450,000, she worries about an "incestuous merry-go-round in which no-one questions the culture of ever-higher pay because they all benefit from that culture." This will carry on, she warns, "like some Escher artwork" until the mutual back-scratching is ended. Foges doesn't want worker representatives to have any power of veto but she does hope that worker voices on boards might at least challenge the existing culture.

Britain's coalition government did introduce modest measures in the Enterprise and Regulatory Reform Act of 2013[114] to bring more openness to executive and directors' pay. Some remuneration committee reports have been almost unintelligible—perhaps deliberately so. In order to tackle the problem of impenetrably complex pay packages companies are now required to publish a 'single figure' detailing the total remuneration that their chief executives receive in any one financial year. Alongside this single figure companies must now publish historic comparisons of CEO pay and what relationship it has to the company's underlying performance and to other employees' pay. The ERRA also requires there to be a binding rather than advisory shareholder vote on pay policy at least once every three years. There is a specific requirement to get shareholder approval for any exit payment that amounts to more than one year's basic salary or otherwise exceeds the minimum contractual severance arrangement.

It is perhaps too early to judge this Act's full effectiveness—the only successful rebellion so far against pay was against the engineering firm, Kentz[115] in May 2014—but there are other signs that the reforms might be working. We have already noted the modest moderation in CEO pay.

Some top CEOs still aren't responding to the new climate, however, and they are insulated by the institutional conservatism of institutional shareholder groups. Requiring a super majority of shareholders



Above: An "incestuous merry-go-round in which no one questions the culture of ever-higher pay because they all benefit from that culture".

Illustration by Carla Millar

(perhaps 66%) to approve CEO and director pay packages might help to overcome that conservatism. The introduction of such a super threshold would need to include provisions to avoid it being abused by a single, vexatious minority shareholder with another unrelated agenda but it would also be a neat companion reform to the UK government's plans to guarantee healthy turnouts in strike ballots run by trade unions.

Such a reform might further encourage the large institutional investors to spend more time listening to activist shareholders as Vanguard, Black Rock, State Street and Legal & General are already doing. Quoted in *The Economist*, Vanguard Asset Management's controller of funds, Glenn Booraem hopes big investors will become "passive investors but active owners".[116] Mr Booraem explains more on his company's website.[117]

CEO pay and reward structures don't just matter because of fairness and equality. They matter because shareholder and management objectives should be aligned. We had a classic example of dangerous misalignment recently. Martin Winterkorn, the former chief executive of Volkswagen, set out to make VW the world's biggest car manufacturer by sales volume by 2018. His ambition to overtake Toyota and

General Motors was succeeding and he was rewarded with the biggest pay deal seen on a German stock exchange-listed company. But you don't treble sale volumes in the US—which was vital to his strategy—easily. You do it, we now know, by deceiving regulators with "defeat software" as technically brilliant as anything else in one of the Wolfsburg-headquartered company's cars. Allowing Mr Winterkorn to set such a grandiose target—with huge upside gains for him but few downside financial personal risks—created a massive misalignment of shareholder and management interests. For capitalism to retain public faith we need a system where the rich can get poorer as well as the poor richer. There need to be snakes as well as ladders in the boardroom board game.

POSTSCRIPT II: BRINGING A BUSINESS BRAIN TO THE NOT-FOR-PROFIT SECTOR

It is not just the corporate boardroom where thinking needs to evolve, there is also enormous scope for the thinking of charities to evolve. Frank Prochaska, a historian of the charity sector at Oxford University, has calculated[118] that 27,000 British charities receive more than three quarters of their income from taxpayers. The overall percentage is 38 per cent, up from 10 per cent in the 1970s. When you get such a large amount of money from the state you get infected by its risk-averse mentality. Whereas business people often abandon failing projects because they can't afford mounting losses, bureaucrats tend to throw more money at schemes that aren't working because loss of face is a bigger worry to political paymasters who rarely like to admit defeat.

And this is why philanthropy by successful businesspeople should be judged by the change in culture it generates in the not-for-profit sector as much as by the sums that are given. 127 of 1,645 known billionaires have agreed to give away more than half their wealth as part of the Giving Pledge. They will never give as much as welfare states to fighting poverty and some, including Mr Gates, have questions to answer about the aggressive tax avoidance of the businesses that made them their wealth. Overall, however, the value of Michael Bloomberg's donations to urban renewal projects, or Mark Zuckerberg's to education, is that these adventurist minds bring to the fields of social policy the same disruptive thinking that made them rich.

In their 2008 book *Philanthrocapitalism*,[119] Matthew Bishop and Michael Green examine the "value added" that successful business people can deliver to good causes. They highlight the New York City Leadership Academy which trains new school principals at a cost of $150,000 per head. Modelled on General Electric's John F Welch Leadership Center its aim was to build "a team of 1,400 great principals who are true instructional leaders, who can inspire and lead teachers, students and parents in their school community." There would have been public outcry if taxpayers' money had started the academy and such large sums had been lavished on a few individuals. Because it was funded by the Broad Foundation, however, it was successfully established and after proving its worth it was incorporated into the New York schools budget by Michael Bloomberg when he was the city's mayor.

On pages 281 to 282 of their book, Bishop and Green summarise the role of corporate philanthropists by pointing to a story of how their role is misunderstood in popular culture:

> "In the penultimate episode of *The West Wing*, a favourite TV show of policy wonks, a multibillionaire Gates-like character tried to head-hunt White House chief of staff C J Cregg to run his foundation. She initially declines, but urges him to build roads in Africa. There is plenty of evidence that roads and railways are good for an economy and good for poor people, but C. J.'s advice was wrong. Infrastructure is hugely expensive to build

and costs a lot to maintain, as the English philanthropists in the Renaissance found out. All the philanthropic capital in the world could not build enough roads to make a real difference in Africa—and within five years they would be falling apart with no one to maintain them. Public and for-profit private capital should build roads.

To achieve leverage, philanthropists should not be competing with or substituting for government money; they should be trying to improve the way it is spent. Likewise, companies and NGOs will be only too happy to take a philanthropist's money, but they may be far less keen on the more valuable things the philanthropist can offer: insight and advice. Nor is leverage just about resources. The state is better placed, for reasons of legal power and accountability, to do some things, like creating welfare systems that provide universal coverage with consistent standards and without discriminating against particular individual groups. By taking responsibility for the whole system, governments can also minimise bad incentives—for example, by ironing out poverty traps. Governments tend to be hopeless at risky innovation, on the other hand. Likewise, public companies are good at taking an idea that works and growing it fast to a massive scale, but they do less well at investing in ideas that have an uncertain or long-term payback."

6 An undeserving class of rich people and businesses depend upon anti-competitive relationships with government for their success

There was once a time when politicians bought "treats" for electors. In his biography of William Wilberforce (2008), the former British Foreign Secretary William Hague set out the scale of the hospitality that nineteenth century parliamentarians offered to their prospective electors. On one occasion the Grosvenor family of Chester spent £8,500 over the course of an election to buy the support of locals. That £8,500 bought 1,187 barrels of ale, 3,756 gallons of rum and brandy and over 27,000 bottles of wine. I can only assume the alcohol wasn't all consumed in one day or the electors would not have found their way to the voting booths—let alone remember where to place their cross.

It is the other way round of course today. Some contemporary American politicians spend four hours per day[120] on "call time"—raising money. As it gets closer to election time Senators can spend two-thirds[121] of their time seeking donations. British politics is not entirely immune from the influence of money either. Just look at appointments to the House of Lords. An exhaustive survey carried out by academics at Oxford University found[122] a statistically extraordinary link between donating to a political party and becoming a member of the Upper House. Looking at the likelihood of donating to a political party and winning a peerage they likened the probability to entering the National Lottery and winning the jackpot five times in a row. Perhaps surprisingly, the Tories turned out to be the cheapest. The average entry fee for a Conservative donor was £220,000; £333,000 for a Liberal Democrat; and £464,000 for a Labour wannabe.

And what do donors get in return for their money? The billionaire Donald Trump has said a few controversial things on the campaign trail in the summer of 2015 but in one moment of extreme candour he did what few donors to political parties ever do—he admitted[123] that he gave in order to receive:

> "I will tell you that our system is broken. I gave to many people, before this, before two months ago, I was a businessman. I give to everybody. When they call, I give. And do you know what? When I need something from them two years later, three years later, I call them, they are there for me. I'll tell you what, with Hillary Clinton, I said be at my wedding and she came to my wedding. You know why? She didn't have a choice because I gave."

Most donors don't give in order to get political heavyweights to turn up to their latest wedding but what do they give for?

GIVING IN ORDER TO RECEIVE

Most, in my limited experience of British Conservative politics, genuinely give because they believe in a political cause. They give because they are Eurosceptics and the Tory Party is Eurosceptic. They give because they are friends of Israel and the Tories are (generally) friends of Israel. The money follows the belief rather than the other way round. In particular, it's rare in most advanced western nations for there to be a direct link between donations and the awarding of a contract. Most contracting of government services is carried out by independently audited public servants and is hard to corrupt. Money does buy other kinds of special privileges, however. For example:

» **Complex regulations:** Contrary to popular belief many big businesses quite like and seek regulation.[124] If you are a major Wall Street bank you can afford large compliance departments and top tier lawyers to both design and then navigate complex regulatory systems. Regulation can actually be of huge public benefit to your firm if it leads to the public thinking you are safe for them to contract with. Because a bank, for example, is overseen by a government body, investors can believe that their money is safe—or at least investors had that assumption before the 2008 crash. An extensive regulatory system is much harder for a small, upstart financial institution to cope with. The unit costs of regulation fall much more heavily upon them. All of this was set out by George Stigler in his 1971 arguments about "regulatory capture". Government departments or agencies that are set up to promote the public good become captured by the entities that they are supposedly masters of. There is also the generally depressing economic impact of regulation. Antony Davies of Mercatus Research reports:[125]

> "Over the period 1997 through 2010, the least regulated industries experienced 63 percent growth in output per person, 64 percent growth in output per hour, and a 4 percent decline in unit labor costs. Over the same period, the most regulated industries experienced 33 percent growth in output per person, 34 per cent growth in output per hour, and a 20 percent increase in unit labor costs."

» **Licences to work:** This is another version of the same problem. Anyone wanting to enter a particular trade or profession needs to cross certain hurdles. Sometimes those hurdles are proportionate and are in the public interest. They guarantee that the public is served by properly trained people. Far from always, however. The US-based Institute for Justice investigates[126] the occupational licensing system and fights the hurdles to accreditation that simply amount to restrictionist barriers to entry. The attempts to regulate the braiding of hair[127] being a depressing case in point. In these circumstances, accreditation schemes become constructed with the connivance of well-connected businesses who want to frustrate possible competitors.

» **Picking winners:** While direct lobbying for a subsidy for an individual firm is unusual in advanced nations it is not so unusual for whole sectors. In recent years the renewables energy sector has won considerable subsidy from government for investing in technologies which the likes of Bill Gates believes are immature and are consequently a waste of public money.

» **Excessive forms of patent protection:** The composers of the *Happy Birthday* song Mildred and Patty Hill—died long ago. Mildred Hill in 1916. Patty Hill in 1946. The owners of the music—Warner Chappell—have nonetheless benefited from generous copyright laws that allow owners of copyrighted material to claim royalties from it for 70 to 95 years (see Ross Clark in *The Times*).[128] When copyright or patent laws are too protective of invention for too long it stops encouraging innovation and R&D—instead it encourages companies owning patented material to wring more profit out of existing inventions. The need to fix the patents system was the subject of a recent cover editorial by *The Economist*.[129] While inventors deserve recognition and reward for their efforts there is a strong case for shorter lengths of copyright protection—especially in industries where the development period is shorter. "Protection for 20 years might make sense in the pharmaceutical industry," thundered *The Economist*, "because to test a drug and bring it to market can take more than a decade." It continued: "But in industries like information technology, the time from brain wave to production line, or line of code, is much shorter. When patents lag behind the pace of innovation, firms end up with monopolies on the building-blocks of an industry." From the opposite ends of the spectrum the libertarian Cato Institute and Joseph E Stiglitz agree.[130] At the same time there needs to be more protection of patent holders from frivolous legal trolling.[131] Since the 1980s patent trolling in the US has increased by 600% with—according to research quoted in the *Harvard Business Review*[132]—a very damaging impact on R&D spending. Mike Montgomery at *Forbes* worries[133] that "innovators cannot build companies in the face of meritless patent lawsuits"—especially if they come from protectionist governments like France.[134] Litigation could be reduced if patents weren't so vague[135] and broad but, unfortunately, a recent bipartisan effort[136] by Senators Chuck Schumer and John Cornyn to shift the burden of proof to patent litigators and from patent holders is stalling in America's gridlocked Congress.

» **Export credit regimes:** The argument for giving export guarantees[137] to big exporting companies is that other countries' industries will win export contracts if they aren't offered by their own country's government. The problem is that they can socialise risk and privatise reward if firms aren't charged adequate fees for what is essentially a heavily subsidised insurance policy. When some leading American Republicans decided that they were no longer willing to fund the US Export-Import Bank one of its major beneficiaries—Boeing—cut off the donations it made to those politicians. The transparency of their actions were Trump-like. You can argue that ExIm guarantees are necessary if the likes of Boeing can't buy similar guarantees commercially but it is also clear what and who is being bought.

» **Too Big To Fail financial policies:** These are examined separately in chapter ten.

THE DESERVING RICH AND THE UNDESERVING RICH

Speaking at the 2015 Conservative Party Conference Michael Gove, the UK Justice Secretary, made a distinction between the deserving rich and the undeserving rich. The deserving rich, he said, work hard, are creative and add value to society. His target, in contrast, was an undeserving rich who play the markets, rig rules and sit on each other's remuneration committees. He called for today's Conservatives to tackle the undeserving rich with the same determination as the monopoly-busting Teddy Roosevelt demonstrated when he tackled the anti-competitive practices of his time. Mr Gove specifically singled out people at the World Economic Forum in Davos who lecture the rest of the world on the importance of competitive markets but still get handsome reward packages if and when they fail.

Iain Duncan Smith, the Work and Pensions Secretary, was quick to agree with the Lord Chancellor's analysis. No free market Conservative should begrudge people who have risked everything and built a business and created jobs from being handsomely rewarded. But, Mr Duncan Smith continued, in recent years capitalism became associated with a financial system that was quick to punish small business people or private households who fell into financial distress. Someone who didn't pay back their loans on time was blacklisted on credit files for many years, for example. But when those same banks and financial institutions got into trouble themselves they were bailed out by government and a different set of rules seemed to apply. If the rich can't get poorer because the system protects them, the system loses legitimacy.

Now, is a good time to return to the very beginning of chapter one where we noted Andrew Lilico's reaction to the huge government bailouts of Wall Street and the City of London. Let's quote some more of his wisdom:[139]

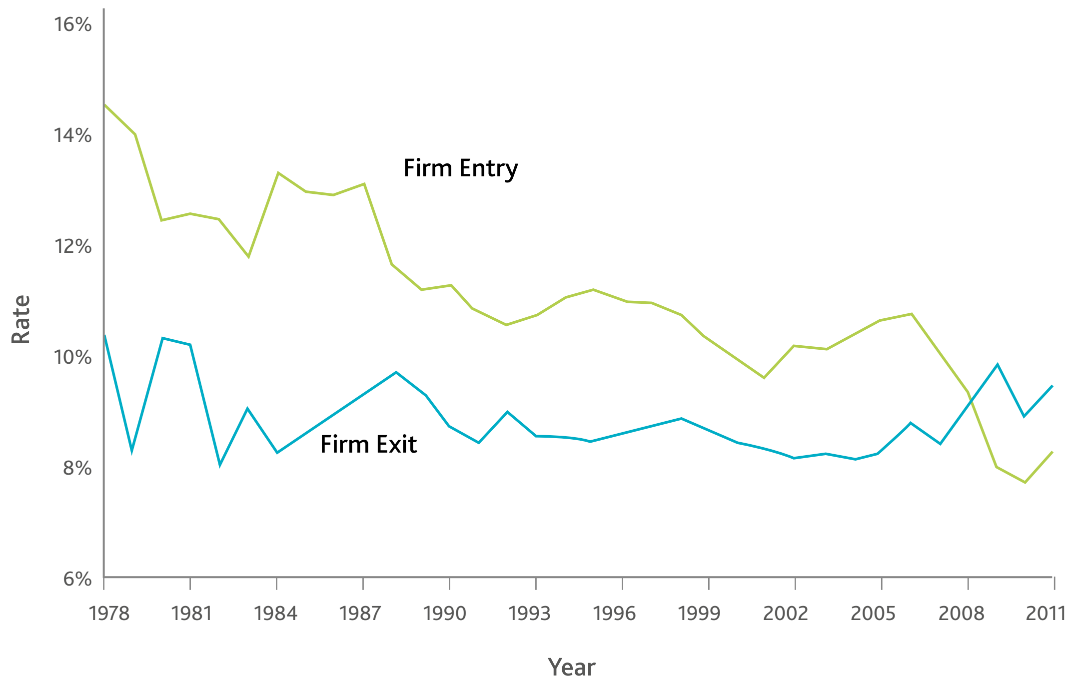
> "Capitalism is all about responsibility—if your ideas don't work, you don't make money; if you fund the wrong projects, you lose your money. Capitalism is a system of consequences—failure (through incompetence, laxity or bad luck) has the consequence of loss. Consequences for failure is a central part of what Capitalism is about. If failure is forbidden—if the state intervenes to bail out banks, to bail out their bondholders and depositors—then we don't have Capitalism."

Above: Michael Gove, the UK Justice Secretary spoke at an event hosted by the Legatum Institute and TheGoodRight.com at the 2015 Conservative Party Conference. He is pictured with the Business Secretary Sajid Javid, and Tim Montgomerie.

And here we get to the heart of why crony capitalism doesn't just raise moral questions but also raises concerns about the dynamism of advanced economies. The OECD believes[140] that the "diffusion machine"—the process by which good ideas are translated by businesses into product—is breaking down. Some say that innovation in general is slowing down (notably Robert Gordon)[141] but the OECD has a different explanation. It blames government policies—often designed to protect the environment or the status of a profession—but which add up to favouring incumbents across a whole range of areas.

The problem is particularly great in Spain and Italy:

> "In countries where this pattern is particularly prevalent—Italy and Spain—the OECD said better use of workers skills could boost productivity by as much as 10%. The OECD's analysis has echoes of the "zombie firm" hypothesis used by some economists to explain weak productivity growth in the immediate aftermath of the financial crisis. In that analysis, state-supported banks were discouraged from calling time on problem loans, thus allowing



Above: The US economy has become less entrepreneurial over time Firm Entry and Exit Rates in the United States 1978–2011

James Pethokoukis for the American Enterprise Institute

Source: US Census Bureau, BDS; James Pethokoukis' calculations

> businesses that otherwise would have failed to survive. But the OECD's analysis suggests there is a more general problem with the way markets are working."

James Pethokoukis, writing for the *National Review*, fears[142] that excessively close relations between government and corporates is undermining the "creative destruction" that Joseph Schumpeter correctly identified as essential to the forward momentum of capitalist societies:

> "New companies made up roughly half of all American businesses in 1982 versus just a third today. These findings suggest big problems at the heart of America's version of entrepreneurial capitalism. Start-ups generate the "disruptive innovation" that creates new goods, services, and jobs. And they force established businesses to try to match them. Without competition from new companies, old ones will pursue only the sort of "efficiency innovation" that makes production cheaper, often by replacing people with machines. The U.S. still generates lots of innovation

> overall, but maybe too much is of the job-killing sort rather than job-creating kind that marks a dynamic economy."

On the American Enterprise Institute's website he published graphs that underlined his thesis about declining entrepreneurialism (see left).

CRONY CAPITALISM HAS NEVER BEEN EASIER TO ENGINEER...

Throw Them All Out: How Politicians and Their Friends Get Rich off Insider Stock Tips, Land Deals, and Cronyism That Would Send the Rest of Us to Prison[144] is a book by Peter Schweizer—the William J. Casey Fellow at the Hoover Institution, Stanford University. The title is certainly "WYSIWYG"—What You See Is What You Get. Interviewed about his book by the Acton Institute he explained[145] why he thought crony capitalism was a bigger problem than ever before—bigger than ever before because of the size of government and the complexity of contemporary legislation:

> "Two hundred years ago, they might try to get a railroad going through their land and they might buy up the land beforehand. That sort of thing goes on, but in an area where literally the federal government is handing out tens of billions of dollars in loans and grants, the amount of money that can be made and the opportunities are just so much greater than they've ever been historically, and that relates to the size of the budget and the amount of money that's being passed around. I think the second thing is it's also more widespread because it's harder to detect. Things in Washington now are so much more complex and difficult to follow that it's easier to camouflage what you're doing. If you've got, say, a healthcare bill that is 2,000 pages long, it's very easy to have some small clause in there that's going to have some huge benefit to a certain industry or a certain company. And if you're on the inside and know that and can trade stock based on that information, that presents a huge advantage that didn't exist before. Likewise, I use the example of former Speaker of the House Dennis Hastert. If you can insert an earmark into the highway bill, it's a lot easier to cover your tracks than it would have been 100 years ago when the size of bills and the role of government was much smaller. The amount of money and the complexity of government both make it much more opportunistic for people to engage in this kind of stuff."

...AND IT SHOULD REALLY BE CALLED POLITICISED CAPITALISM

The Economist has stated[146] that we need "a revolution to save capitalism from the capitalists" but it takes two to tango. The capitalists are only half of the problem. Laziness, ideological failure or pure greed have led politicians to form socially harmful relationships with powerful business lobbies. We probably shouldn't call it crony capitalism but politicised capitalism. We need to tackle the idea that people in government are more angelic or wiser than people in free enterprise. Reform might need to begin within the economics profession.

Economic textbooks are routinely full of the study of "market failure" and market failure, of course, provides the pretext for government intervention. But governments fail, too. There is the problem of policy by special interests of the kind described above and the growth of middle class entitlements as described in the next chapter. There is also the short-termism that neglects investment in long-term infrastructure spending and instead prioritises the spending on immediate "goodies" that can help win votes at elections. In a 2014 survey the economists Jim Gwartney and Rosemarie Fike[147] analysed 23 of the most common economic textbooks used in America and found that they were, on average, six times as likely to cover market failure as government failure. Don Boudreaux[148] of George Mason University notes that the *New York Times* economics columnist Paul Krugman did not mention[149] government failure or public choice theory once in his introductory book to economics.

CORRECTING CRONY CAPITALISM

Crony capitalism will not be beaten back by any one policy. It will require sunset regimes for regulations so that they automatically expire after a short period unless there is a good case for them to continue. A broad simplification of the tax system so that well-connected industries can't get special favours designed into the system. More teeth for competition authorities so that they can act against oligopolistic or predatory behaviour. Reform of patents. And, perhaps most importantly, limits on political donations.

Crony or phony capitalism reflects a corrupt form of entrepreneurialism. In *The Great Divide* Joseph Stiglitz identifies the capitalists who have found innovative ways of persuading the government to protect their market status, and calls it "socialism for the rich". A clean up should include general limitations on the amount of money that business or wealthy individuals can donate to political parties and special prohibitions on donations during sensitive political times. 27 US states, for example, have stopped politicians from soliciting or receiving campaign contributions when legislatures are sitting. Unfortunately the big picture remains gloomy in the US. "The Supreme Court," wrote Stiglitz,[150] "in its recent Citizens United case, has enshrined the right of corporations to buy government, by removing limitations on campaign spending. The personal and the political are today in perfect alignment".

AND THEN THERE IS BRAZIL AND CHINA AND OTHER DEVELOPING NATIONS

This chapter has focused on the problem of crony capitalism in advanced nations. It is probably a bigger problem in developing countries. Here's *The Economist*:[151]

> "Capitalism based on rent-seeking is not just unfair, but also bad for long-term growth. As our briefing on India explains (see article),[152] resources are misallocated: crummy roads are often the work of crony firms. Competition is repressed: Mexicans pay too much for their phones. Dynamic new firms are stifled by better-connected incumbents. And if linked to the financing of politics, rent-heavy capitalism sets a tone at the top that can let petty graft flourish. When ministers are on the take, why shouldn't underpaid junior officials be?"

Overall we have seen the wealth of billionaires in sectors characterised by cronyism double in relation to the overall size of the economy—from 2% of GDP in 2000 to 4% today. Developing countries, concludes *The Economist*,[153] "contribute 42% of world output, but 65% of crony wealth."

We know that unhealthy relationships between business and government can mean that bad practice is enshrined. In China, for example, according to research quoted in the *Harvard Business Review*,[154] the rate of worker deaths is five times greater at politically connected companies than at similar companies that lack friends in high places. Brazil's Petrobas oil company has become a perfect example of when relations between enterprises and politicians get too close. The Brazilian police are investigating allegations that senior managers in the country's most important company diverted about 3% of contracts to the ruling Workers' Party and its allies. This isn't just a question of rank corruption. It has meant an incredibly important firm has been spectacularly badly led with investment projects mismanaged and money sunk in poorly thought-through schemes. One of the most important and neglected arguments for privatisation of state-owned or state-orbiting enterprises is that they cease to be politicised and they focus on maximising profits and, hopefully, purpose.

POSTSCRIPT 1: THE SOCIAL JUSTICE FUNCTION OF SMALL FIRMS

Ensuring that small businesses are not subject to unfair competition from bigger, politically-connected firms is not just in the interests of entrepreneurs and family-sized firms. It is also in the clear interests of some of the most vulnerable members of society. That is the conclusion of Tom Papworth of the London-based think tank, Centre Forum. He argues[155] that the oft-repeated claims by politicians that small businesses drive economic growth and innovation may be overstated. He does discover, however, that small and medium-sized enterprises (SMEs) are most likely to provide work for the unemployed. Examining UK employment statistics he finds that "92% of movements from unemployment or non-participation into private sector employment are due to the individual starting up or being employed by an SME." He continues:

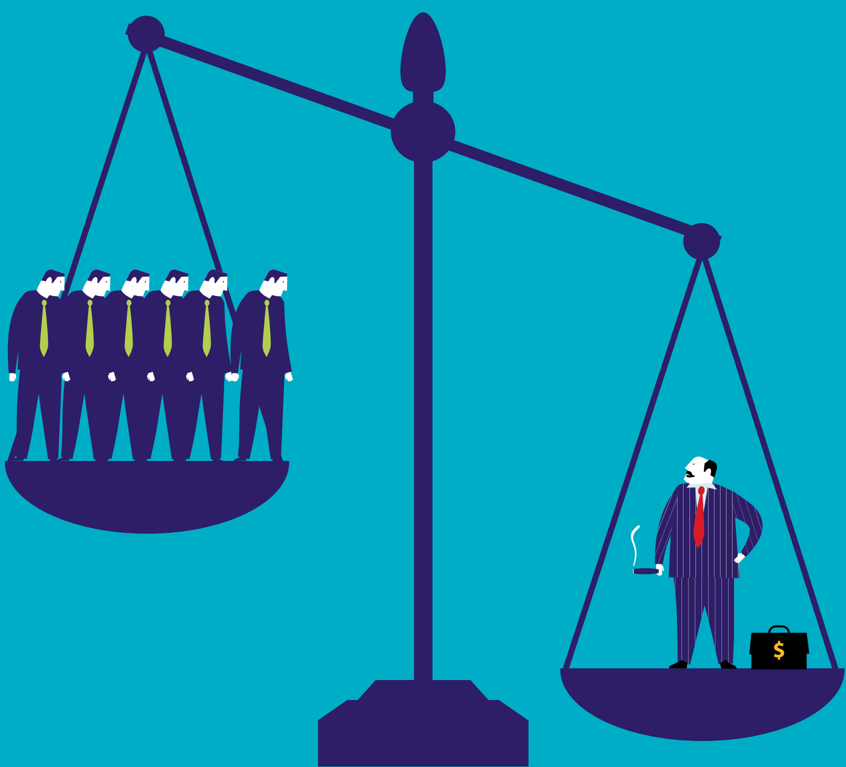
> "Those working in SMEs are more likely to come from groups that have experienced relatively more hardship during the recent recession. For example, young people (aged 16 to 24), people above retirement age and those without a university degree who move from worklessness to employment are less likely to find jobs with companies employing more than 250 workers than mature adults and those benefiting from higher education. Medium sized businesses in particular are responsible for a greater proportion of employment in areas of the UK with higher unemployment (i.e. not the South or East of England) and especially in the North East and Wales, which have amongst the highest rates of unemployment. High growth medium-sized businesses are particularly important to job creation. Whereas 65% of medium-sized firms achieve less than 1% employment growth, two-thirds of jobs created by medium-sized businesses emerge from just 6% of those firms."

Minimising any and all unemployment should be a top priority of any government. It is not, after all, a temporary blight upon people. Mark Carney, Governor of the Bank of England has warned that "a rise in unemployment by 5 percentage points is estimated to imply an average initial loss of earnings for new college graduates of around 9 per cent, an effect which is estimated to fade only after a decade." Even short-term unemployment can have long-term effects.

ECONOMICS *of* PROSPERITY

LEGATUM INSTITUTE

7 The state cannot reduce inequality by taxing the rich or penalising the poor: it must control middle class entitlements



The YouGov polling[156] presented as part of this analysis demonstrated very clearly that voters in all parts of the world are more worried about poverty and unemployment than inequality or the existence of a super-rich elite. But friends of capitalism should not close their eyes to the gap between the top and the bottom.

INEQUALITY IS GROWING

The OECD has argued[157] that inequality is still growing in developed nations. Thirty years ago the top 10% of earners received seven times as much as the bottom 10%. That multiple is nearly ten now—although some believe it reflects a growing gap between the top 0.1% and everyone else rather than the top 10% and everyone else. The "gap" is particularly wide in America. Janet Yellen, the chairperson of the Federal Reserve has noted[158] that the average income of the top 5% of households grew by 38% over the last quarter century but grew by less than 10% for all other households. Some of these statistics are disputed. Inequality hasn't grown so much if you calculate final incomes (after benefits and other transfer payments) rather than market incomes (simple wages). It's also better to measure inequality over the full length of economic cycles rather than at the beginning of a recovery. This is because inequality often widens during tough years of famine but declines during feastier years.

And then there's the question of whether we should measure inequalities of income, wealth or consumption? Inequalities of wealth provide the most depressing picture (and have grown because of quantitative easing—£375 billion in Britain alone)[159] but greater access to a whole range of consumer goods amongst even the lowest-paid provides the basis for arguments that this is an age of unprecedented equality. Even the poorest people in advanced nations have access to food, entertainment and medicine that a king or president couldn't enjoy fifty years ago. All of us in the West are certainly richer than Pharaoh Ramesses II,[160] the great pharaoh once regarded as the most powerful man on earth. Richer in access to medicine, culture and technology—even travel.

Any increase in inequality within advanced nations should also be examined alongside global reductions in inequality. Tyler Cowen has reported[161] "good evidence" that the rise of Chinese exports has held down the wages of some parts of the American middle class—just as immigration of low-skilled workers into the US has had a negative impact on the wages of lower-skilled Americans. At the same time both changes have benefited the wealthy within America—because of the stocks they own in global companies that invest in China and because it's cheaper for them to hire cleaners, home helps and other more menial workers. Overall it's an encouraging picture—but not without some serious complications for lower income citizens of the more mature economies.

INEQUALITY SHOULD CONCERN FRIENDS OF THE FREE MARKET

At the end of the 1980s the British Tories did exhibit a tendency to diminish inequality and relative poverty. In a speech entitled "The End of the Line for Poverty"[162] the then social security minister John Moore suggested that the war on poverty was over because the "stark Dickensian poverty" of the previous century had been abolished. On becoming Tory leader nearly two decades later, David Cameron begged to differ:

> "Even if we are not destitute, we still experience poverty if we cannot afford things that society regards as essential,... The fact that we do not suffer the conditions of a hundred

> years ago is irrelevant… Fifty years from today, people will be considered poor if they don't have something which hasn't even been invented yet."

In the third chapter of this *Prosperity for All* report I urged friends of capitalism to rediscover the moral seriousness of Adam Smith. That rediscovery should include his musings on inequality and his recognition that the nature of poverty changes over time:

> "A linen shirt is, strictly speaking, not a necessary of life. The Greeks and Romans lived, I suppose, very comfortably though they had no linen. But in the present times, through the greater part of Europe, a creditable day-labourer would be ashamed to appear in public without a linen shirt, the want of which would be supposed to denote that disgraceful degree of poverty which, it is presumed, nobody can well fall into without extreme bad conduct."

STRENGTHS AND WEAKNESSES OF THE PIKETTY ANALYSIS

The central contention of Thomas Piketty's *Capital in the Twenty-First Century* is that capitalism inevitably increases inequality and some factors would appear to confirm his side of the argument:

» There are the new technologies that replace labour with machines—increasing unemployment whilst richly rewarding their inventors.

» There are, as Tyler Cowen noted (see p61), the disproportionate benefits to the wealthy that flow from investments in emerging markets and because of some immigration.

» Then there are unequal rates of inflation for different social groups. Average rates of inflation have been higher for poor Americans in 139 of the last 168 months[163] according to the Federal Reserve. Additionally, many of the poor, for example, get poorer because they pay more for their electricity than the rich—because they are unable to pay with direct debit or benefit from corresponding discounts. The pattern is repeated for other basic services.· They also pay more to borrow or cash cheques. A report by Matt Fellowes and Mia Mabanta for the Brookings Institution estimates[164] that exclusion from basic banking services can cost a full-time worker $40,000 over their full career.

» The rich meanwhile either buy private education for their children or buy themselves into the catchment areas of good schools. Advantage begets further advantage.

» They then help their children on to the housing ladder. The London property market provides a particularly good illustration of the Piketty thesis that capital earns more than labour. The daily increase in the value of some London homes exceeds the income that many people can earn from any salaried job. The tightly-regulated nature of land use in Britain—"socialism rather than capitalism"—might be the key causal explanation for this phenomenon but, whatever the cause, those already owning properties in major global hubs like London are getting much richer still—and at the expense of those yet to get their feet on the housing ladder.

Not every trend validates the Piketty thesis, however. There are some powerful trends in the other direction, too, which suggest inequality need not grow. Reviewing Piketty, Bill Gates has blogged[165] that there is still enormous social mobility and social churn in otherwise unequal nations like the United

Above: Creative destruction: capitalism and innovation constantly challenge big businesses.

Blockbuster, Birkenhead, Merseyside. February 2013.

Source: © Rept0n1x

States: "Take a look at the Forbes 400 list[166] of the wealthiest Americans. About half the people on the list are entrepreneurs whose companies did very well (thanks to hard work as well as a lot of luck). Contrary to Piketty's rentier hypothesis, I don't see anyone on the list whose ancestors bought a great parcel of land in 1780 and have been accumulating family wealth by collecting rents ever since."

Blockbuster, the video rental company. Borders, the bookseller. Woolworths, the UK and US supermarket chain. Ratners, the jewellery chain. The DeLorean Motor Company—that survives today only in celluloid, as the time travelling car of the "Back to the Future" movies. Pets.com, the petfood seller that heralded the (first) dotcom bust. TWA, PanAm and Eastern Air Lines, the airlines that went bankrupt. Arthur Andersen, one of the big five accountancy firms that collapsed because of its role in "auditing" Enron. And, of course, Lehman Brothers. Capitalism is a system of constant (creative) destruction.

Gates chastises Piketty for only looking at the factors that increase inequality—rather than those that also erode it. He cites "instability, inflation, taxes, philanthropy, and spending". By spending he means the conspicuous consumption of some rich people. Yachts and £10,000 handbags spring to mind. Research from the Williams Group[167] wealth consultancy—highlighted by the *Wall Street Journal*—shows that family money doesn't cascade down the generations for long. 70% of inherited wealth has evaporated by the end of the second generation and 90% by the third. The old proverb "shirtsleeves to shirtsleeves in three generations"—an American translation of the Lancashire proverb "there's nobbut three generations atween a clog and clog"—seems to be holding true.

The Left think you can solve the deficit problem by taxing the rich...

The Right think you can solve the deficit problem by squeezing the poor...

The well-fed elephant in the room, however, is the middle class—and their entitlements

If public policy is to continue to ensure some fairness in "final incomes" some tough questions need to be asked of politicians and their current spending priorities. So much of existing public spending goes to marginal/battleground electorates rather than to the most deserving. It goes to pensioners who tend to vote rather than to young people who are more likely to stay at home—even though younger people are poorer on average than older people. It subsidises landlords through housing benefits rather than the next generation through the building of new homes. Those concerned about inequality should fix the priorities of the welfare state before they even begin to think of making government even bigger. Given tax competition across the world it might be the only option. Mark Littlewood of the London-based Institute of Economic Affairs believes that advanced nations like Britain may be at the limit of what they can levy on footloose business and high net worth individuals (see point seven of this ten point briefing).[168]

At a recent Georgetown University seminar on poverty, President Obama advocated a number of investments to help the poor—notably in infrastructure—but Arthur Brooks of the American Enterprise Institute urged him to confront the elephant in the room—middle class entitlements. "Why," he argued,[169] "are cities like Detroit or the federal government facing serious fiscal problems? Not because they have low tax rates, or because they are spending exorbitant amounts on infrastructure and education. It is primarily because of guaranteed, middle-class transfers (pensions, Medicare, Social Security, etc.) that are crowding out the ability to pay for other public goods." As Mitt Romney memorably opined: about half of Americans are "takers" rather than "makers"—at least for part of their lives. In Britain—according to the Centre for Policy Studies[170]—51.5% of households are receiving more from the State (in cash benefits and benefits-in kind) than they are paying in taxes. This may be a deep-seated "bug" in how democracy works. Most of us squeal when the government threatens our winter fuel allowance or child benefit, for example, but the stealthy taxes that politicians impose in order to fund those benefits hit us more gradually and are harder to notice.

When Congressman Paul Ryan—now Speaker of the US House of Representatives—came forward with a plan to bring America's deficit under control a few years ago it was warmly received by the US Right and made a considerable contribution to him being chosen as Mitt Romney's running mate for the 2012 presidential election. But the Ryan plan hardly touched entitlement programmes like Medicare (accounting for 16%[171] of total federal spending) or Social Security (accounting for 37%[172] of all federal spending) which benefit most Americans. In sharp contrast, wrote Derek Thompson[173] for *The Atlantic*: "Medicare would hardly be cut and Social Security would see exactly $0.00 in cuts. In the next decade, Ryan's plan is essentially a vision of America where deficits fall because government assistance to the poor and sick rapidly shrinks. It solves our income inequality problem like a flamethrower helps a house fire." But, as Alan Viard has argued[174] in a briefing paper for the American Enterprise Institute (AEI), true entitlement reform has to hit upper and middle income groups, as much as lower income groups:

> "The Congressional Budget Office's latest long-run projection of current budget policy does show rapid growth for one low-income entitlement. Medicaid [targeted on lower income Americans], together with related health subsidies, is slated to grow from 1.9% of GDP in 2011 to 3.7% in 2035. But, that 1.8-percent-of-GDP expansion is overshadowed by the 4.3-percent-of-GDP expansion—from 8.5 to 12.8%—slated for Medicare and Social Security. Meanwhile, all other federal programs are slated to shrink from 12.3% of GDP to 8.5%...
>
> "It's disturbing that the agriculture portion of the bill includes $36 billion of food stamp cuts while leaving subsidies for middle-income and upper-income farmers completely unscathed...
>
> "The long-term fiscal gap won't be closed by undermining the safety net for the bottom 20%, any more than it will be closed by merely raising taxes on the top 1 to 3%. To close the gap, those in between—the middle class, broadly defined—will have to bear much of the burden, through a mixture of entitlement cuts and tax increases."

British Conservatives are cutting more equitably than the "Ryan-ite" Republicans in the USA (and Ryan himself has been on something of a journey since his original plan) but are still struggling to tackle the biggest middle class entitlement of them all: the basic state pension. The Tory government has promised retired people a "triple lock" on their state pension. Under this "lock" their pension will grow by at least the rate of inflation, the average level of earnings or by 2.5%. This lock is both inequitable and hard-to-afford. It is regressive because the Institute for Fiscal Studies calculates[175] that pensioners are now better off, on average, than the working age population, and the state pension is growing at a time when income supplements for low income workers are being cut back. The lock is also deficit-denying according to the British Government's own Actuary Department. The *Financial Times* reported[176] that "The extra cost of the triple lock, compared with an earnings uprating, is projected to add about 9 per cent to benefit expenditure by 2040, rising to around 23 per cent by 2070. But this figure could balloon to 11 per cent in 2040, and 41 per cent by 2070 under a "new normal" scenario of low inflation, low earnings growth. However, in a "Japan deflationary" scenario, triple-locked pensions could cost 238 per cent more than earnings-linked pensions in 2070."

THE INVERSE CARE LAW

Middle income groups have always been effective at maximising their take from government services. Julian Tudor Hart's "inverse care law" was proposed[177] four decades ago but it still holds true. Annette

Hastings and Peter Matthews of the LSE recently identified,[178] for example, the considerable evidence that middle class people are able to get more from universal services because of their social-cultural skills: "In schooling, it might mean getting your child prioritised for specialist educational interventions or in health longer consultation times with your GP. Planners might avoid siting controversial projects in your locality in anticipation of concerted protest." But it is in protecting their benefits that the middle classes are most effective. One of the most politically difficult cuts made by the Conservative Chancellor George Osborne during the 2010 to 2015 parliament was a restriction of child benefit[179] to those earning more than £44,000. Tory insiders say the organised resistance to this measure by sections of the electorate who are more likely to vote than poorer workers explains the subsequent failure to trim benefits for the better off.

Deficit cutting might become fairer across the generations and across different income groups if voter turnout was more even. It is far from representative at present. About 76% of pensioners cast a ballot at the 2010 British general election but only 44% of first-time voters did. 76% of higher income voters in the better-off AB social class turned out, but only 57% of DE voters did. It's similar in the USA. Turnout can reach 78% amongst those earning more than $150,000 pa but be as low as 41% amongst the poorest.[180] 41% of 18 to 24 year olds turned out to vote in the 2008 presidential election but 70% of over 75s exercised a vote. One way of addressing this problem would be to introduce compulsory voting. Belgium, Brazil and notably Australia are among about 30 nations that already require their citizens to turn up at the ballot box and the new Prime Minister of Canada, Justin Trudeau, has promised to consider introducing it for his country. Anyone who loves freedom will be at least a little bit uncomfortable at the prospect of compelling people to vote (ballot papers would have to include a "none of the above" option) but a greater problem would be if advanced nations became a modern equivalent of gerontocracies where older and richer people decide the political and fiscal priorities of a nation. Compulsory voting isn't primarily about compelling voters. It's about compelling politicians[181] to reach beyond their comfort zones. It's a 20-minute burden for voters once every four or five years but it might compel our politicians to change in fundamental ways and to build much broader and more representative voting coalitions. Short of introducing full compulsory voting would be a reform that required just first-time voters to turn up at polling booths. There is some evidence that this encourages the voting habit. Another more radical solution to this problem would be "Demeny voting". Based on an idea from nineteenth century demographer Paul Demeny this would give parents extra voting power so that they could ensure the interests of minors were reflected in a government's priorities. Reihan Salam examined "a conservative case" for enfranchising children in the *National Review*. Personally I like the idea but readily recognise its chances of being enacted equal about zero!

The bailouts only increased the middle class dividend. As Andrew Lilico has observed, the primary beneficiaries of the bank bailouts were not the banks themselves but the middle classes:

> "The main people the bailout saved were ordinary savers, pensioners, homeowners, folk with net assets of £200,000 to £1m.They are the key origins of "capital", not some "1%". If you want a system that is properly fair and just, you need to be willing to see those with £200,000 fall back to having £150,000, or those with £1m sometimes fall back to £400,000 or £100,000. Just as "intergenerational justice" regarding house prices is nothing to do with £20m Chelsea mansions but everything to do with £600,000 houses in the shire counties, so economic justice with respect to capital versus work is little to nothing to do with a few billionaires but, instead, everything to do with hundreds of thousands to millions of people with £200,000 to £1m net assets."

Confronting middle class entitlements rather than Piketty's unrealistic idea of a global wealth tax is a more likely path to affording anti-inequality policies (notably early intervention and housebuilding programmes). The one country that did embrace a super tax on the wealthy—Piketty's native France—has already decided it was counterproductive and has abandoned it. It would need to be global in order to stop the rich jumping from high tax jurisdictions to low tax climes but the chances of any worldwide agreement on a super tax is next to nil. Even Demeny voting would be easier to introduce. The same governments that for twenty years have failed to agree action against climate change are unlikely to all suddenly join hands and sign up to a global tax regime.

Insofar as tax policies can be used to tackle inequality it will have to be imposed at the level of nation states, modestly and shouldn't be focused on income. Already in Britain the top three thousand income taxpayers pay more tax than the nine million lowest-paid income taxpayers. Inequality is greatest in wealth and property rather than income and that's where any new taxes should fall. According to Janet Yellen the lower half of US households (by wealth) held only 3% of all wealth in 1989. By 2013 they only held 1%.[182] Any new taxes should be imposed on properties because they can't be hidden or, as Bill Gates suggests, luxury consumer goods. In Britain that could and should include new council tax bands for higher value properties. Ideally progressive property and consumption taxes would be replacement rather than new taxes and should fund reduced income taxes for the low-paid. There is certainly no global demand for higher taxes overall. A plurality or majority in 22 of the 44 electorates surveyed by Pew Research[183] want lower rather than higher taxes. Electorates in 13 of the 44 nations preferred high taxes with slow growing European electorates most ready to accept the state extracting more. Tigerish Asian and African nations were most enthusiastic about low taxes.

ASSET-BASED SOCIAL POLICY

Mrs Thatcher had the right idea in the 1980s when she transferred the ownership of local authority housing and nationalised companies to private ownership. A larger middle class emerged as more people owned their own homes and shares. Wider ownership of such assets gives more people a stake in the success of capitalism. Margaret Thatcher's mistake was not to do a lot more to encourage replacement housebuilding. The decline in housebuilding[184] has left millions of people living in insecure, often cramped and usually expensive private rented accommodation. That's bad for family life, bad for social justice and bad for faith in free market systems. Capitalism won't survive in democracies if fewer and fewer people own capital.

INEQUALITY IS A MUCH MORE INGRAINED PROBLEM THAN THE LEFT REALISES

Building on the theme of chapter four and the importance of society this chapter should end by reinforcing the importance of social capital. The truth is that, if the Left is correct about the rise of inequality, it ignores the social roots of the phenomena. The liberal economist Noah Smith[185] has come to accept the diagnosis of the libertarian social commentator, Charles Murray. In *Coming Apart* Murray documents the growing gap in moral behaviours between the elites of America and the lower middle classes. Between elites that marry and non-elites that do not. Between elites that embed their children in strong social networks and non-elites that are isolated and members of weak social groups. Worse of all, complains Murray, the elites don't preach what they practice: they support forms of public policy that undermine marriage. The Marriage Foundation[186] has found the same trends in the United Kingdom.

In an essay for *Foreign Affairs*, entitled "Capitalism and Inequality" (2013), Jerry Muller, Professor of History at the Catholic University of America,[187] notes that the inequality that exists today does not result from inequality of opportunity. Most formal and informal barriers that once might have prevented ethnic minorities or women from advancing are heavily eroded—if not entirely overcome. (There is probably still much further to go in empowering people with disabilities). Today's inequality largely stems from unequal abilities to exploit opportunity. He presents the case that those with strong, nurturing families are given huge advantages in being able to enjoy what free societies have to offer. He notes that education—the preferred panacea of many on the liberal Left—is not a sufficient answer. "One of the most robust findings of contemporary social scientific inquiry," he writes, "is that as the gap between high-income and low-income families has increased, the educational and employment achievement gaps between the children of these families has increased even more."

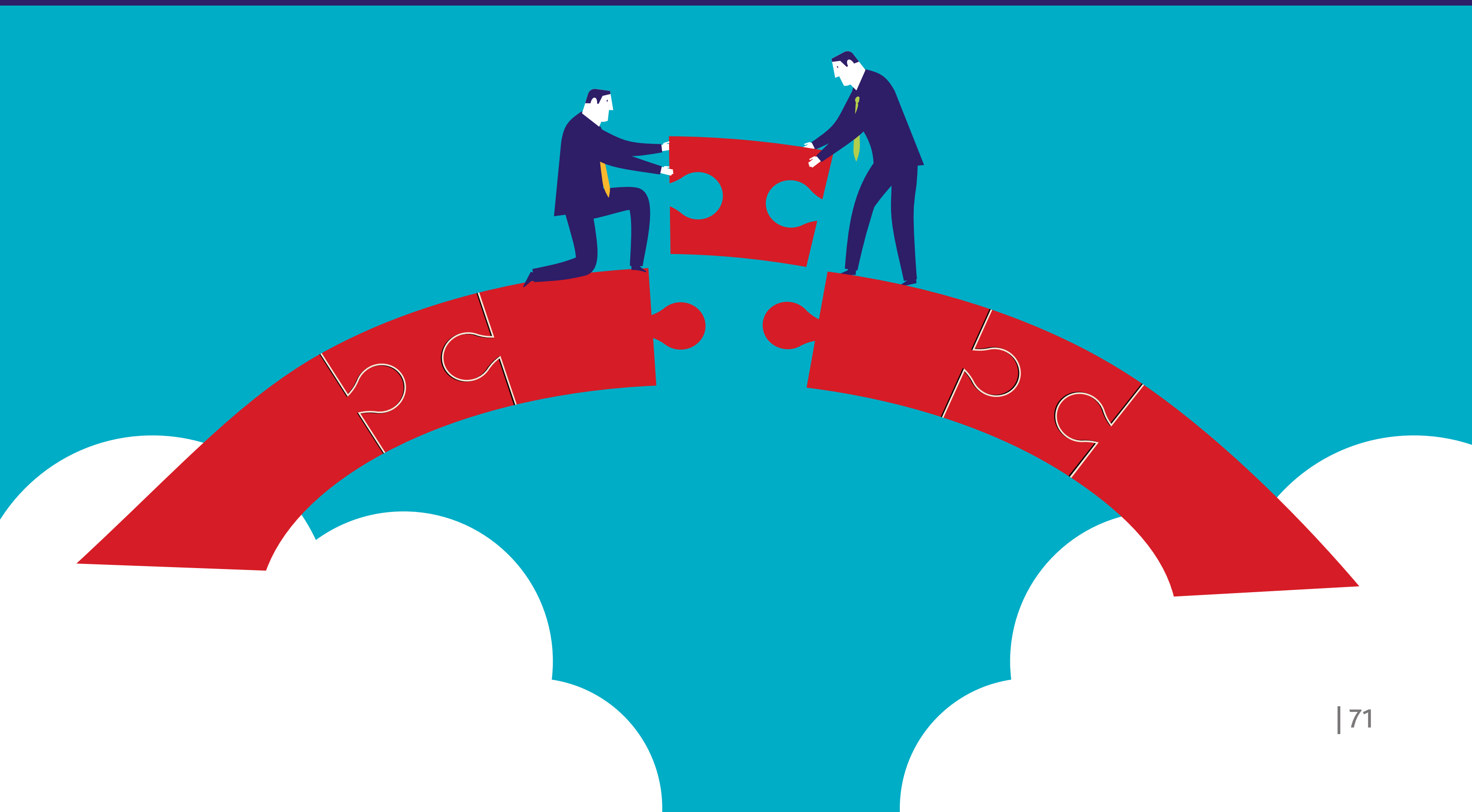
Robert D Putnam is another left-of-centre thinker who realises that the relational isolation of poorer American children is crippling their life chances. Speaking to US National Public Radio as part of the launch programme for his latest book, *Our Kids: The American Dream In Crisis* (2015)[188] he explained the challenge:

> "It's one of the things that we discovered when we talked to rich kids and poor kids around America, that we didn't expect—but kids, like my grandchildren and, like, you know, probably, like, your children or grandchildren, all across America have a lot of adults in their life that are reaching out to help them. They tell them about what it means to go to college... They describe, you know, how you can get through high school properly and where you can find a fellowship and—the bottom line of all of the statistics in our study is that poor kids are increasingly isolated from everyone. They just don't have stable, responsible adults in their lives much of the time. And that means they're just really ignorant. Not because they're stupid, but because they don't have mentors and adult helpers that most of us had when we were growing up."

Yet again we learn that materialism is not enough. Relationship breakdown and economic hardship are not, of course, unrelated. If libertarian and liberal politicians need to end their indifference to family structure some change is also needed from cultural conservatives. Low pay, the deskilling of the working class and the consequences of high incarceration rates have all reduced the pool of "marriageable men"—men that women would like to marry and are candidates to be good fathers.

The "Marriage Opportunity Council"[189] has been established in the United States—bringing together people of Right and Left—to discuss what a pro-marriage agenda might look like in an era when the divisive issue of same-sex marriage is moving towards being settled and new opportunities for co-belligerence can arise. When economists from the Federal Reserve estimate[190] that 52% of new forms of inequality reflect changing family structure it is vital that public policy does take a relational turn. A more relational public policy was the focus of chapter four.

8 Governments focused on the short-term business of elections have neglected one of their most important tasks: investment in infrastructure



Fiscal hawks talk repeatedly and correctly about not expecting the next generation to pick up the tab for this generation's over borrowing. But there are other ways to cheat the next generation and one way is to fail to make the kind of year-by-year investment in roads, railways, airports and general R&D that underpin long-term prosperity.

Our children don't deserve to inherit a country with second class infrastructure—not least because if infrastructure is allowed to decay that infrastructure cannot be rebuilt quickly. Failure to make adequate capital investment is especially inexcusable when interest rates are historically low and it could be financed at minimal cost.

Britain's Labour Party presented many silly policies at the May 2015 general election. The silliest policies involved suppressing the free market—including rent controls on private landlords and an energy price freeze. There was also the proposal to increase the top rate of income tax even though there was little evidence that it would produce extra revenue. It seemed to owe more to the politics of envy than a politics of equality or deficit reduction. But Labour did have one eminently sensible economic policy. Ed Balls, Labour's Treasury spokesman, wanted to borrow *more than* David Cameron's Conservatives for capital spending (investment in infrastructure). The policy generated little purchase from the electorate because voters didn't believe the other key component of Labour's fiscal policy—that it would achieve a surplus on the current budget (spending that covers day-to-day departmental costs, including wages, pensions and welfare benefits). Because Labour hadn't supported any tough decisions during the 2010 to 2015 parliament it lacked the fiscal credibility to be trusted to borrow more for investment. With interest rates at historically low levels, however, Labour's policy on borrowing to invest was the right one. The government could choose to borrow at 1.5% for the best part of two decades and it's short-sighted that it does not.

US AND UK INFRASTRUCTURE IS NOT IN GOOD SHAPE

The major Anglo-Saxon capitalist economies simply aren't spending enough on infrastructure. The United States, the home of capitalism, ranks 28th in global infrastructure spending and according to the American Society of Civil Engineers (ASCE) the cracks are beginning to show. The ASCE awarded[191] the US an overall D+ grade. Solid waste management got a B- and bridges, ports, railways and public parks got a respectable C grade. Energy, transit, aviation, levees, dams, schools, roads, inland waterways, wastewater, hazardous waste and drinking water all got various D grades. The last time the US spent adequately on infrastructure was in the 1950s and 1960s. Since then public spending on infrastructure has declined[192] to only half of the European average.

The UK—that other model of Anglo-Saxon capitalism—isn't doing much better. Over the coming two to three decades £20 billion is needed to ensure British water systems cope with drought and increased population. £100 billion is required to electrify railways, improve mass urban transit, build roads and airports. Another £100 billion is needed for communications infrastructure, including broadband and smart metering. The biggest bill will be to deliver energy security. An estimated £250 billion[193] will be needed by 2045 to keep the lights on and meet binding decarbonisation targets. Then there is the need to stabilise house prices by doubling annual housebuilding to something like 250,000 units per year—and support that extra housing with the appropriate transport, health and educational infrastructure.

The 2011 national infrastructure plan[194] commissioned by George Osborne noted that the UK performed well compared to other OECD countries in coverage and cost of telecommunications and also in the reliability of electricity and gas supply. The same plan recognised, however, that many UK power stations were ageing, train punctuality was worse than in much of Europe, air capacity was a looming weakness and that road congestion was a growing problem. Fast forward to today and that airport decision is still to be taken. And addressing the House of Commons in his seventh budget as Chancellor in July 2015, George Osborne noted that the roads problem was particularly acute: “four fifths of all journeys in this country are by road, yet we rank behind Puerto Rico and Namibia in the quality of our network.” His source for this fact is the *Global Competitiveness Report* of the World Economic Forum. He continued: “In the last 25 years, France has built more than two and a half thousand miles of motorway—and we’ve built just 300.”

Unfortunately, despite Mr Osborne’s rhetoric, the problem has got worse since the great recession struck. Constantly wearing a hard hat and a hi-visibility jacket, George Osborne wants to give the impression that this is a government that is rebuilding the nation’s infrastructure and a “Northern Powerhouse” in particular. Unfortunately, capital spending has been falling. From 2009 to 2014[195] capital spending was cut by about a third in inflation-adjusted terms; from about £57 billion per year to just £42 billion. Moreover Britain wasn’t starting from a particularly strong position. The latest declines in investment spending are only part of a much longer-term trend. The Institute for Fiscal Studies (Briefing Note BN43, August 2014)[196] underlined the long-term decline in net government investment. From the mid-1950s to the mid 2010s current expenditure rose from 34.5% to 42.4%. Much of this increase is explained by the rising costs of pensions and healthcare; to the extent that the NHS and welfare bills now account for more than half of all government expenditure. Over the same six decades investment spending fell by 50% to 65% depending upon which measures are used. Public sector net investment equals just 1.4% of GDP[197] at the moment and isn’t projected to rise significantly during this parliament. At that percentage the British State is probably committing only half of what it ideally should be spending.

POLITICIANS SPEND TOO MUCH ON WELFARE AND TOO LITTLE ON INFRASTRUCTURE

If George Osborne does not want to take the borrowing-to-invest path—or can’t find ways of inducing corporates sat on huge cash piles to invest—he has other options and he has alighted upon cuts to welfare. “We’ve got 1 per cent of the world’s population,” he has said, “4 per cent of its GDP, but we undertake 7 per cent of the world’s welfare spending.” In that configuration he was channelling Angela Merkel and her memorable observation that Europe may account for only 7 per cent of the world’s inhabitants and a declining 25 per cent share of global GDP but it finances half of all social spending. Merkel and Osborne, two of Europe’s great advocates of austerity, agree that its future prosperity depends upon reducing benefit bills and affording better roads, railways and schools. When spending on welfare brings short-term *political friends* and spending on infrastructure only brings long-term *economic gains* you can understand why a democracy might lead to more of the first than the second kind of spending.

Welfare cuts may not be enough, however, to modernise infrastructure. Welfare cuts may not even be sufficient to eliminate Britain’s structural deficit—let alone afford a doubling of capital spending.

Pensions and healthcare are the real drivers of increased government spending and they are squeezing out much possibility for George Osborne to increase capital spending and meet his controversial surplus target.

There is a particular problem of investment in science and technology.[198] Whereas Israel, for example, spends roughly 4% of its national income on R&D (current and capital, public and private) Britain spends just 1.7% and the USA 2.7%.

Government can get infrastructure wrong by spending too much as well as too little, of course. China, it is said,[199] is characterised by "thousands of empty cities, ghost airports and unfinished skyscrapers—investment in infrastructure that will never provide a return." But democracies may be underinvesting because politicians don't benefit quickly from spending on projects which only deliver long-term dividends. One solution might be greater use of earmarked taxes for infrastructure projects. America's Centre for Transport Excellence found that infrastructure projects were approved 75% of the time when voters were consulted in ballot initiatives. This suggests that direct democracy might be a way of getting past the short-termism of politicians.

A DOMESDAY BOOK FOR THE TWENTY-FIRST CENTURY

One other key way of addressing the lack of investment in public infrastructure would be to embrace the ideas put forward by Dag Detter, a Fellow of the Legatum Institute, and Stefan Fölster in their new book *The Public Wealth of Nations: How Management of Public Assets Can Boost or Bust Economic Growth*. Their idea is as simple as it is potentially revolutionary and you might be as surprised as I am that it is not an idea that has not already been embraced: the idea that our governments put management of national assets (like urban space, forests, state-owned enterprises and the resources beneath publicly-owned land—like shale gas) in the hands of independent, transparently-run National Wealth Funds (NWF). The Funds would be free of day-to-day political interference and the expert NWF asset managers would be free to sweat the assets under their control to maximise public gain—but always within the context of social goals enshrined in their terms of reference. Singapore's government-owned holding company Temasek[200]—which has environmental and social objectives set in its charter—is probably the best model of what the authors hope other governments might embrace but, even within Europe, there is Austria's Österreichische Industrieholding AG and, more recently, Finland's Solidium.

Detter and Fölster's key conclusion is that "the global total [of these assets] is twice the world's total pension savings and ten times the total of all the sovereign wealth funds on the planet." The exact sum they come up with of $75 trillion ($21 billion greater than the worldwide estimate of total public debt) may be a significant understatement because it does not include the assets of local and regional governments. "If professionally managed," they continue, "the $75 trillion of assets could generate an annual yield of $2.7 trillion, more than current global spending on infrastructure." Even a 2% increase on the return of public assets could generate $1.5 trillion more for the public purse. The potential for increased return will vary wildly from one country to another. Countries like Brazil where assets such as Petrobas have been managed incompetently and corruptly in equal measure, will potentially have most to gain. Detter and Fölster claim[201] that every percentage point of improvement on annual global portfolio returns would generate the equivalent of the GDP of Saudi Arabia. The percentage of public assets currently under expert management is estimated at just 1.5%.

Many countries are ill-equipped to set up National Wealth Funds because they do not even have a record of the assets they do own. Many countries, notably Greece, have no proper land registry. The authors estimate that only 7% of Greece has even been properly mapped. *Cash in the Attic*[202]—published by the Adam Smith Institute two years ago—identified £40 billion of public assets within the UK that could be readily privatised but even countries like Britain and New Zealand which do have national asset valuation assessments "would most likely never have passed accountancy standards in a private sector company". When I interviewed Dag Detter[203] for the Legatum Institute I suggested countries needed to first prepare twenty-first century "Domesday Books" to correct this ignorance. Such catalogues could then allow the inevitable public debate on this idea to occur in the most informed possible way:

We have seen in Britain how the privatisation of some forestry land—and also moves towards fracking—have met huge public resistance. Although the authors are suggesting that national assets should be kept in public hands there will still be significant opposition to a more commercial use of environmentally-sensitive assets in particular—especially if cash-strapped governments set portfolio managers on paths that encourage short-term profit maximisation. The public debate about which assets can be "sweated" and on what criteria is likely to be an extended one. The Detter-Fölster approach is nonetheless potentially a richly rewarding one. The public may decide to give National Wealth Funds very limited powers and very limited portfolios at first but that does not preclude them growing over time if they start to build public confidence that commercial management is often a better route to environmental and social stewardship than managing public assets bureaucratically or not even managing them at all.

The new chair of the UK government's National Infrastructure Commission—Lord Adonis—is an admirer of the ideas contained in The Public Wealth of Nations.[204]

LEGATUM INSTITUTE

9

The extension of free trade to every corner of earth remains the last best hope: poverty can only be history when protectionism is history

When the likes of Blair, Clinton and Schroeder dominated global politics from the late 1990s and until the economic crash of 2007/2008 the G8 summits tended to focus on the Left's top priorities, including combating climate change and increasing overseas aid budgets. The mood of the era was captured by Richard Curtis' Emmy Award-winning drama, *The Girl in the Café*.[205]

This TV film was produced by the BBC and HBO to coincide with the Gleneagles summit of 2005. It was proof—if proof is needed—that it is in drama where the BBC's political agenda is strongest. At the time Tony Blair and Gordon Brown were seeking legacy-defining commitments from other world leaders to increase aid spending to tackle poverty in the developing world. Their ambitions were supported by that year's powerful "Make Poverty History" campaign.[206] Commitments to double aid to the poorest parts of the world were made and by 2010 some $30 billion of the extra $50 billion had been given (although countries like Britain rather than backsliding Italy were largely responsible).[207] Although Oxfam was disappointed at the failure to fully meet pledges the UK-headquartered development charity was relieved that substantial progress had nonetheless occurred—and during a horrendously difficult period for the world economy.[208] Much less impressive was the failure on climate change from the summits of the period. That failure culminated in the disastrous UN gathering in Copenhagen, in December 2009.

Since the global crash the centre-right has been in the political ascendancy but it is not evident that global summitry has changed to match this political change—perhaps because Barack Obama remains the most powerful politician in the world and he largely shares the Blair-Clinton-Schroeder worldview. No great effort has been made to restart global free trade talks. The bilateral and regional agreements that have become the norm in the gap left by the absence of global talks have been a mixed blessing—reducing some protectionism but increasing the hotchpotch of market access standards. If centre-right governments were interested in producing a global agenda as well-intentioned as that of their left-wing predecessors but with the potential to do much more good they wouldn't look to that 2009 Copenhagen summit or the Geleneagles summit but to Bjorn Lomborg's Post-2015 Consensus, a successor to his Copenhagen Consensus framework for choosing policy priorities.[209]

Conscious that many summits are hijacked by special interest groups or by ideas that sound good in final communiqués Mr Lomborg put together 62 teams of economists, including a number of Nobel Laureate economists, to identify the smartest ways of spending limited resources. The Lomborg project found that lowering barriers to trade was by far the most useful project that world leaders interested in global justice could pursue.

A free trade deal across Asia and the Pacific would generate $3,438 of benefits for every $1 spent. That compares to providing contraception which would produce estimated benefits per dollar spent of $120; reducing tax evasion which would have a 49:1 pay off; doubling HIV medication which would be beneficial by 10:1; and vaccination against cervical cancer would have a 3:1 strike rate.[210]

Mr Lomborg also uses his analysis to argue that many of the climate change lobby's preferred policy actions—embodied in the Kyoto Treaty—are expensive and ineffective.[211] He recommends, instead, that reductions in fossil-fuel subsidies and the investments in green technology of the kind associated with Bill Gates are much more likely to produce a cleaner environment. But let us return to his number one recommendation: and the power of freer trade.

ECONOMISTS DON'T AGREE ON MUCH BUT THEY AGREE ABOUT FREE TRADE

Was Keynes or Friedman right about the causes of inflation? Was Keynes or Hayek right about the merits of government intervention during recessions? Should exchange rates float or be fixed? Should we tax consumption or income? If you get three economists in a room you are supposed to get at least six opinions. So goes the joke at the capacity of practitioners of the dismal science to disagree with one another. But on free trade there is rare and wide agreement—partly because of the difference between free markets at home and free trade overseas. The governments of China and France, for example, like their large state-owned enterprises to be able to compete freely in global markets.

Earlier this year fourteen previous chairs of the US President's Council of Economic Advisers—including Martin Feldstein, R Glenn Hubbard, Ben Bernanke and Austan D Goolsbee—wrote a letter to the leaders of Congress supporting the extension of free trade agreements.[212] Economists who had worked for the Ford, Carter, Reagan, Clinton, Obama and both Bush administrations were united in writing that "expanded trade through [free trade] agreements will contribute to higher incomes and stronger productivity growth over time in both the United States and other countries." An October 2014 analysis by Matt Slaughter of the Tuck School of Business at Dartmouth College would appear to confirm this. Commissioned by HSBC, the report found that US exports more than doubled from $1.04 billion in 2003 to $2.26 trillion in 2013; that international trade had boosted the income of average American households by $13,600 per year; and that the pay of employees of exporting and importing firms was 15% to 20% higher than firms focused on the domestic US market. [213]

Explaining why he was one of the letter's signatories, Gregory Mankiw, Professor of Economics at Harvard University, referenced Adam Smith: "Just as no sensible person tries to make all his own clothes and grow all his own food, he said, no sensible nation will aim to achieve prosperity by isolating itself from other nations around the world." Ever since Smith and his observation that "consumption is the sole end and purpose of all production", free traders have been allies of consumer rather than producer interest groups.[214]

One very real event in the last century reinforced the free trade consensus amongst economists—just as the eighteenth century wisdom of Smith inspired it. Eighty-five years ago America indulged in one of the greatest acts of economic self-harm in its history. The Smoot-Hawley tariff bill of 1930—the unhappy legislative offspring of two Republicans: Senator Reed Smoot and Congressman Willis Hawley—increased nearly one thousand duties on imports to America. Other factors were more important in creating the Great Depression but Smoot-Hawley exacerbated the economic hardship and introduced trade restrictions into the global trading system that took decades to fully unwind. According to the US Department of State, American imports from Europe declined from a 1929 high of $1,334 million to just under $490 million by 1932.[215] US exports to Europe fell from $2,341 million over the same period to $784 million. Over the five years from 1929 to 1934 world trade shrank by a catastrophic 66% as nations engaged in round upon round of beggar-my-neighbour retaliations. Economists were united in opposing the bill at the time. Reflecting on the law in an article for the *American Economic Review* in June 1942 Princeton University's Austrian school economist, Frank Fetter wrote:

> "With the sharp division of economic opinion in recent years on so many issues of public policy, it is hard today to realise the almost unanimous opposition of economists, in the spring of 1930, to the tariff bill then pending in Congress. Economic faculties that within a few years were to be split wide open on monetary policy, deficit finance, and the problem of big business, were practically at one in their belief that the Hawley-Smoot bill was an iniquitous piece of legislation."[216]

Smoot-Hawley didn't just hurt the world economy. It contributed to the geopolitical tensions of the 1930s. Japan, denied the ability to buy resources from once key trading partners, invaded those territories instead, for example. The politicians of the period ignored the insights of Richard Cobden, the so-called "apostle of free trade". Cobden, a Manchester industrialist, joined with John Bright to repeal nineteenth century restrictions on imported grain—restrictions that were enshrined in the Corn Laws and which raised the price of basic foodstuffs for the working poor. For Cobden trade was about so much more than material enrichment. "I would not step across the street just now to increase our trade for the mere sake of commercial gain," he wrote, "but to improve moral and political relations of France and England, by bringing them into greater intercourse and greater dependence, I would walk barefoot from Calais to Paris."

On another occasion he said:

> "The people of the two nations [France and England] must be brought into mutual dependence by the supply of each others' wants. There is no other way of counteracting the antagonism of language and race. It is God's own method of producing an entente cordiale, and no other plan is worth a farthing."[217]

Thomas E Donilon, President Obama's former National Security Adviser, embraced the spirit of Cobden in 2001, claiming that there has been no time in human history that a nation of diminished economic vitality has also maintained global security.[218]

BUT BEYOND ECONOMISTS THE FREE TRADE CONSENSUS IS UNDER ATTACK

But if the near consensus amongst public policy-making economists has endured over the decades it appears to be breaking down in the political and public sphere. While there has always been a populist, anti-trade streak in American politics (Barry Goldwater campaigned against John F Kennedy's support for free trade) the consensus amongst most elite politicians was swallowed by a more sceptical, unpersuaded public. But, asks David Frum, what happens when the public's respect for those elites has collapsed—as has now happened?[219]

One manifestation is the unlikely and unofficial Sanders-Trump alliance against free trade. The two leading renegade candidates for the White House in the autumn of 2015—for the Democrats and for the Republicans—may not agree on much but both take populist positions against current US trade arrangements. Democratic Senator Bernie Sanders has declared that "the results are in. Unfettered free trade has been a disaster for working Americans. It is high time we ended our disastrous trade policies." Across the aisle we have the Republican Donald Trump. Fifteen years ago, in *The America We Deserve*, he wrote, he was worried but not defeatist:

> "You only have to look at our trade deficit to see that we are being taken to the cleaners by our trading partners. We need tougher negotiations, not protectionist walls around America. We need to ensure that foreign markets are as open to our products as our country is to theirs. Our long-term interests require that we cut better deals with our world trading partners." [220]

More recently he seems to have lost faith in "tougher negotiations"—calling for a 20% tax on imported goods—to help eliminate various corporation taxes.[221] He is an echo of Ross Perot who stood for the American presidency in 1996. Perot warned America to listen out for a "great sucking sound" if the North American Free Trade Association was passed—as capital and jobs moved south, out of America to "offshore" in cheaper Mexico. Bill Clinton, who inherited the draft NAFTA prospectus from his Republican predecessor, didn't duck the challenge, however. Donning a baseball cap with "NAFTA we HAFTA" emblazoned upon it, he fought for the deal and got it passed. More recently his wife, Hillary, has been less than steadfast.[222]

Although most Americans still think free trade benefits the US economy (by 58% to 33%) only a minority agree that it benefits their own finances (by 43% to 36%). A 44% to 38% plurality of Americans on lower annual incomes (of $30,000 or less) believe that free trade has hurt their own family's fortunes.[223] Another poll—conducted by CBS and the *New York Times*—found that 58% of this lower income group preferred to limit imports to protect industries and jobs. Only 36% preferred the wider selection and lower prices of imported goods available under free trade.[224] The YouGov polling for this report found widespread openness to protectionism—not least in America. There is also some evidence that Republicans are now more anti free trade than Democrats.[225] Fortunately there is also some polling which suggests support for free trade is growing as the post-crash recovery continues.[226] People, perhaps unsurprisingly, are most open to protectionism when times are toughest and when its enactment would be most dangerous—as it was in 1929. Sentiment in Australia today, where growth is slowing because of the derailment of the Chinese resources boom, is turning against free trade. By 49% to 32%, Australians believe the China-Australia Free Trade Agreement negotiated by former prime minister Tony Abbott would be bad for workers.[227] Tourism, big business, exporters and mining are perceived as likely to benefit but skilled workers, manufacturers, farmers, small businesses and middle income households are expected to lose out.

THE TRANSATLANTIC TRADE AND INVESTMENT PARTNERSHIP

Some tout the Transatlantic Trade and Investment Partnership as the biggest trade deal ever for the European Union—boosting the whole continent-wide economy by $130 billion or about $650 per household.[228] America would gain by almost as much. Others, in contrast, say it would be of limited benefit to both sides of the Atlantic. Theodore Bromund, a Senior Research Fellow at the Washington-based Heritage Foundation, said TTIP was the equivalent of offering someone earning £40,000 today a raise in 2029 to £40,200. "That," he wrote, with some understatement, "is not a big effect."[229]

Many on the Right who are normally enthusiasts for free trade are getting cold feet about TTIP because trade agreements between advanced nations do not have the simplicity of yesteryear. The obviously dangerous protectionism of the Smoot-Hawley variety is long gone. The next round of benefits come from eliminating the so-called non-tariff-based barriers to trade. These are the standards for goods and services that pile costs on producers—and therefore consumers—so long as they are substantially different in America and Europe.

There are fears that big businesses will use the complex TTIP negotiations to erect new forms of regulatory privilege. Unlike small enterprises big business has the time, resources and legal know how to dig deep into the minutiae of large and complex, multilateral trade deals and add all sorts of extra detail—on product specification, environmental standards and labour rules—that will help them to survive and prosper today but might make it harder for new businesses to get up and running in the future. The rules, in other words, inhibit innovation, insurgent companies and the "creative destruction" dynamic.

Theodore Bromund concludes that "TTIP promises a lot, but at bottom, it is about creating a process for the US and the EU to make rules together. That is not about freeing the market: it is about controlling

Illustration by Carla Millar

it."[230] Bromund's boss, Jim DeMint, President of the Heritage Foundation has likened the new Congressional process for authorising "free trade" deals to "a special interest boondoggle".[231] Instead of focusing on advancing free trade, TTIP-style deals are cut on human rights, worker safety, and environmental protection. Professor Larry Summers, the US Treasury Secretary at the tail-end of the Bill Clinton presidency, is explicit about this. "Being pressed down everywhere," he writes, "are middle classes who lack the wherewithal to take advantage of new global markets and do not want to compete with low-cost foreign labour." Global companies can no longer be the primary stakeholders in future trade agreements. Instead future agreements must explicitly concern themselves with "economic equity, protection of the environment, opportunities for workers to migrate and financial stability."[232]

American conservatives are particularly concerned at how President Obama might use the fast-track negotiating authority he has—a freedom to negotiate all of the details of a trade agreement and then present that deal to the House of Representatives and the Senate on a take-it-or-leave-it basis.[233] Their anxieties have grown because of his vow to negotiate "the most progressive trade deal the world has ever seen". Will he inject minimum wage rules, renewable energy targets and union empowerment provisions into trade agreements? This may be true but the deals will also protect intellectual property and limit government kickbacks to favoured companies. For free marketeers like Charles Krauthammer and Senators Ted Cruz and Rand Paul this is enough for free trade agreements to still be worth supporting.[234]

There are big national security issues at stake here too. Trade is not enough in itself to guarantee peace but beggar-my-neighbour protectionist battles can cause hardship and exacerbate global tensions—as they did in the 1930s. During the Cold War, America used trade deals to simultaneously promote prosperity and good relationships with strategic partners. Moreover, if the likes of Europe and America aren't negotiating trade deals with Asian countries, China already is and Chinese deals enshrine crony capitalist ways of thinking—where government-owned firms are favoured. As Barack Obama has said:

> "If we don't write the rules for free trade around the world, guess what, China will. And they'll write those rules in a way that gives Chinese workers and Chinese businesses the upper hand."[235]

This is a case of free marketeers not letting the perfect be the enemy of the good. They should certainly fight to limit the amount of social and environmental content in trade agreements—content that should ideally be settled democratically at the level of the nation state. Overall, however, the economic and geopolitical advantages of freer if not perfectly free trade are still worth having.

"THE SOUTHERN SILK ROAD": AFRICA AND SOUTH AMERICA REPRESENT THE NEXT BIG FRONTIERS FOR FREE TRADE

If trade agreements between mature economies like the United States and those of the European Union are unlikely to deliver big gains, that is not true of Africa and South America. Trade between African countries currently accounts for just 13% of total African trade.[236] That compares with intra-regional trade of 70% in Europe, more than 50% in Asia and 21% in Latin America—according to data from the United Nations Conference on Trade and Development.[237] Huge gains for these two regions and the wider world are possible if the next decade or two sees much freer trade across the southern hemisphere.

A free trade area from the "Cape to Cairo" was an ambition of Cecil Rhodes at the end of the nineteenth century—underpinned by a transcontinental railway. More than a century later that vision is still to be realised but the next frontier for free trade is in the developing world and in Africa, in particular, amongst its population of 626 million people (8% of the world's population). It remains much easier for many African states to trade with faraway developed nations than with their neighbours. For most African nations China—with its huge appetite for commodity trade—is the dominant trading partner. Chinese-African trade volumes reached $222bn in 2014, for example. That is more than five times larger than trade between South Africa and the rest of the continent ($41 billion).

June 2015's Tripartite Free Trade Area (TFTA) agreement between 26 of Africa's 54 states—an accord between the Southern African Development Community (SADC), the East African Community (EAC), and the Common Market for Eastern and Southern Africa (COMESA)—suggests that there is some willingness amongst many of Africa's political leaders to move towards free trade but the reality is that it will be some time before the will matches the rhetoric.[238] A patchwork of preferential trade arrangements currently govern trade relations between African states—some of those agreements are poorly-drafted and unevenly enforced and they make it hard for private businesses to predict the true cost of exporting goods and services. Tariffs, complex visa protocols, poorly-protected property rights, inadequate transport connections and unreliable energy supplies continue to place low ceilings on African prosperity. Only when they are overturned will the continent become the economic superpower that many think is possible within the next few decades and we will see Africa's lowly share of total world trade—currently just 3%—start to rise.

There are similar opportunities in Latin America. The continent is currently a story of two groupings and has been since Brazil, Argentina and what was then Hugo Chávez's Venezuela grouped together to kill the "Alaska to Patagonia" Free Trade Area of the Americas as proposed by George W Bush. *The Wall Street Journal* reports that the Pacific Alliance trade bloc (of Mexico, Colombia, Peru and Chile) is growing much faster than the Atlantic-facing trio.[239] The Pacific Alliance has chosen to eliminate tariffs, trim government intervention in their economies and open themselves up to foreign investment. One Brazilian quoted by the Journal summed up the Atlantic bloc harshly: "Brazil is becoming Argentina, Argentina is becoming Venezuela, and Venezuela is becoming Zimbabwe." As the Atlantic bloc model continues to deteriorate and gets over its anti-US obsessions, the hope must be that the whole of South America emulates the Pacific quartet (now joined by Costa Rica) and a new era of prosperity dawns across the whole region. The Pacific Alliance is projected to grow three or four times faster than Brazil over the next few years.[240]

THE MANDELSON EXCEPTION

A final plea. I began this chapter by hoping that centre-right governments would prioritise free trade at global summits. At the same time could centre-right governments put their best people in charge of trade negotiations? It's rare that a politician of the calibre of Lord Mandelson, a British Labour politician, leads the brief. Trade negotiations are less sexy than cutting taxes or increasing spending, for example, and the benefits of successful free trade agreements rarely accrue within a normal electoral cycle. Opposition to free trade does, of course, have time to make itself known before elections. Despite politicians always moaning about the short-term nature of business their failure to champion free trade with appropriate levels of commitment reveals their own very regrettable short-termism.

As David Cameron seeks to renegotiate Britain's relationship with the European Union the completion of the single market in services should be a higher priority. It was one of his priorities when he first launched his renegotiation bid in January 2013. "When the Single Market remains incomplete in services, energy and digital," he told his Bloomberg audience, "the very sectors that are the engines of a modern economy—it is only half the success it could be." He continued: "It is nonsense that people shopping online in some parts of Europe are unable to access the best deals because of where they live. I want completing the single market to be our driving mission."[241] There has not been much evidence that it has been Mr Cameron's "driving mission" even though service sector growth has been greater than manufacturing growth in 13 of the past 16 years within the EU and has potential to grow even faster.[242] Working with the All-Party Parliamentary Group on European Reform, the Open Europe think tank has proposed a range of reforms to "complete" the single market.[243] David Cameron should make progress on single market issues a "red line" issue. Jonathan Lindsell's report for Civitas—explaining how independent, non-EU nations have been able to negotiate faster, more bespoke trade agreements than Brussels—offers an alternative if EU reform fails.[244]

At this point I could launch into extended thoughts on what Britain's exit from the European Union might mean for Britain, Europe and regional trade blocs. On this occasion I'm going to resist the temptation but will return to it in the pieces that I intend to write over the next year—following up on reactions to this report.

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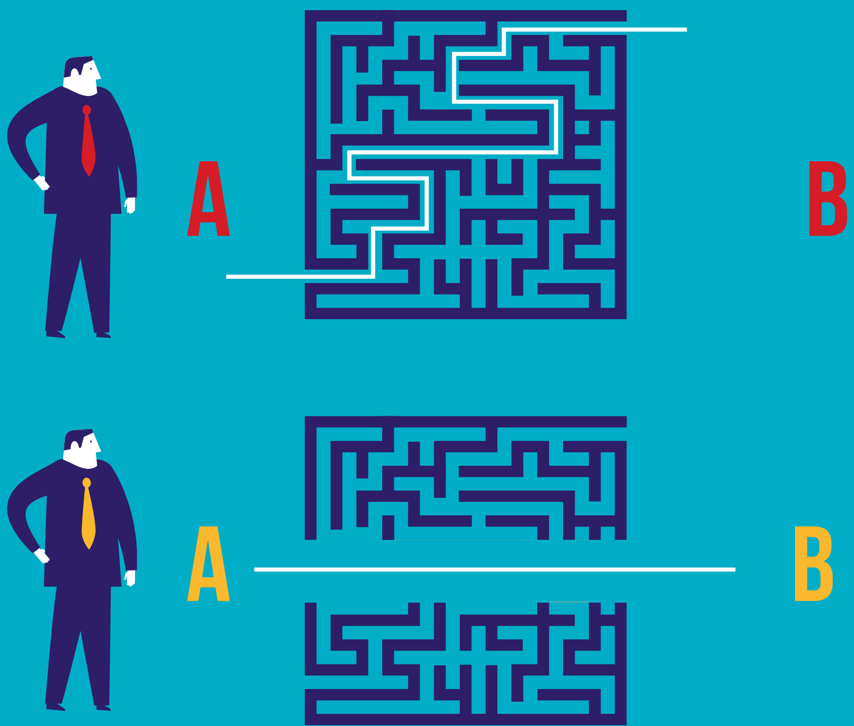
10 Indebtedness, flawed regulatory models, oversized banks, and asset bubbles are the unfinished business of the post-crash decade



The Crash of our era has not been characterised by the social pain of the kind we saw in the 1930s. Many people have lost their jobs. Many have seen public services cut back. Many others have lost trust in the financial services industry and the regulatory authorities. What there hasn't been, however, is mass unemployment. Yes, there has been a rise in food bank use and job insecurity but the "Want" of the 1930s hasn't been repeated. This is partly because of the scale of the response from the global authorities.

Global governments didn't repeat the Smoot-Hawley error described in the previous chapter. We haven't seen trade wars. China and America, in particular, undertook large fiscal stimuli. Even those countries that announced "austerity"—like Britain—have not cut public spending dramatically. Borrowing £100 billion and more each and every year for seven years in a row—as Chancellor of the Exchequer George Osborne has done—adds up to a very cautious form of deficit reduction (the budget deficit is still equal to 4.9% of GDP at the time of writing). Britain's Chancellor borrowed £100bn plus in 2010/11, 2011/12, 2012/13 but £97.3bn in 2013/14 and £89.2bn in 2014/15. Despite the austere rhetoric most finance ministers are in some way Keynesian expansionists.

Moreover the fiscal expansionism has been modest compared to the monetary expansionism. Some estimates suggest that $12 trillion of quantitative easing has taken place since the crisis struck. That's the equivalent of one sixth of world GDP. With interest rates at rock bottom levels for seven years, indebted companies and households that might have struggled to survive in normal monetary conditions have not gone under. In many cases that is merciful but there are perhaps too many zombie companies out there who would have failed by now if they had been subject to normal market disciplines. Potentially storing up problems for the future, monetary abnormality also means that borrowers and lenders are not subject to conventional risk disciplines.

The policy response to the crisis raises two particularly important issues:

» First, if the world economy hits another market crash the same remedies (if they are remedies) won't be available. The public finances of most governments don't have the room for a stimulus that they had in 2008.

» The second great issue concerns whether we have fixed the financial system.... Have we got the right regulatory regime now? Are there still too many banks which are "too big to fail"? Are bankers reformed characters? Will the next episode of asset price inflation meet with a stronger response from the monetary authorities? Has the housing market been fixed?

Let's briefly take each of those five questions in turn. In these subjects I'm straying beyond my intellectual comfort zone and therefore don't pretend to have firm answers to any of the questions—but a paper on post-crash capitalism can't avoid raising them.

HAVE WE GOT THE RIGHT REGULATORY REGIME NOW?

Let's start by knocking down a great myth that has been allowed to grow since 2008. The banks were regulated before the financial crash and heavily. Here's Mark Littlewood of the London-based Institute of Economic Affairs reflecting on pre-crisis regulation within Britain:

> "Look at the financial services sector. Supposedly a hive of devil-may-care, Wild West, free market capitalism. The last time I looked the [Financial Services Authority] regulatory handbook contains 10 sections. The section titled 'Prudential Standards' is divided into 11 sub sections. The sub section 'Prudential Source Book' for banks, building societies and investment firms is made up of 14 sub sub sections. The sub sub section 'Market Risk' is divided into 11 sub sub sub sections. The sub sub sub section of 'Interest Rates' has 66

paragraphs. There are over a million paragraphs in the rule book. Until the late-1970s, bank supervision was performed by the Bank of England with a team of around 30 employees. When the Bank of England was given statutory responsibility over bank supervision in 1979, fewer than 80 people were engaged in the supervision of financial firms. Since then the number of UK financial supervisors has increased dramatically, rising almost forty-fold to around 1,200. In 1980, there was one UK regulator for every 11,000 people employed in the UK financial sector. By 2011, there was one regulator for every 300 people employed in finance. Regulatory reporting requirements have risen too. In 1974 returns could have around 150 entries. Today, UK banks are required to fill in more than 7,500 separate cells of data—a fifty-fold rise. And forthcoming legislation could see that rise to between 30-50,000 data cells spread across 60 different regulatory forms. I don't know how you'd describe such a legal framework. My description probably can't be stated in polite company, but it certainly can't be described as unregulated free market capitalism."[245]

The situation in America wasn't much different. George Mason University's Mercatus Center reported that regulatory restrictions on financial services grew every year between 1999-2008 and regulators reported themselves as content with what they saw. One year before the crash happened in the US, the Federal Deposit Insurance Corporation announced that "more than 99 per cent of all insured institutions met or exceeded the requirements of the highest regulatory capital standards".[246] Regulatory authorities in all parts of the developed world were not short of powers or staff to make such conclusions.

One response to this massive regulatory failure is to call for even more red tape. Another is to call for it to be abolished. Regulatory complexity is certainly difficult for smaller banks to cope with—forcing them out of business and reducing the diversity and therefore the stability of the financial ecosphere. The IEA makes other arguments for slashing regulation. In a 2013 paper written by Forrest Capie and Geoffrey Wood it is argued "that capital regulation is not necessary if banks are not underwritten by the state".[247] It thinks banks simply game the system and everyone gets a false idea of security from an extensive regulatory regime. Investors and depositors stop taking personal responsibility for assessing the quality of a bank and assume that the regulators have it all covered. Regulation may not just be a false comfort blanket—it can also distort and make things worse. It happened with one of the Basle rules that govern how much capital banks must put aside for different types of lending. One required more capital provisions for lending to small business than for mortgage lending. This was a contributory factor to the property bubble and to the reduction in finance to the small businesses that are most likely to generate the jobs of tomorrow.

Whatever the intellectual merits of reducing regulation, the electorates of western democracies are not going to accept substantial deregulation. More likely to succeed is a policy that breaks up the banking sector into smaller entities. Compare Dodd-Frank with Glass-Steagall. Dodd-Frank was the 2010 law enacted by the US Congress in response to our era's financial crisis. It is 849 pages long and contains 398 new rules. It does, in other words, add to the complexity of the pre-crash regulatory regime—and, arguably, the false comfort that that regime engendered. Glass-Steagall was the 1933 reform introduced by US legislators in response to the 1929 crash. Just 37 pages long it prevented the "undue diversion of funds into speculative operations" by banning retail banks from more dangerous speculative or investment operations.[248] It was as wise a response to 1929 as Smoot-Hawley was a stupid one. It was as simple and reassuring as Dodd-Frank was complex and "more of the same". The events of 2008 probably needed structural reform but structural reform hasn't happened on a sufficient scale.

Regulation has introduced the "bail-in" so that the investments of shareholders and the money of creditors are extinguished before claims are made of the taxpayer, but whether for emergency liquidity lines or propping up the banks with capital injections, the taxpayer is still exposed. Moreover, the banks are even larger than they were before the crash. Which brings us to the too-big-to-fail question.

ARE THERE STILL TOO MANY BANKS THAT ARE TOO BIG TO FAIL?

Andy Haldane, chief economist at the Bank of England, wrote for the *London Review of Books* on the growth of "fat" banks:

> "At the start of the 20th century, the assets of the UK's three largest banks accounted for less than 10 per cent of GDP. By 2007, that figure had risen above 200 per cent of GDP. When these institutions hit problems, a bad situation can become catastrophic. In this crisis, as in past ones, catastrophe insurance was supplied not by private creditors but by taxpayers. Only they had pockets deep enough to refloat banks with such huge assets. This story has been repeated for the better part of a century and a half; in evolutionary terms, we have had survival not of the fittest but the fattest… Consider the effects of the too-big-to-fail problem on risk-taking incentives. If banks know they will be bailed out, those holding their debt will be less likely to price the risk of failure for themselves. Debtor discipline will therefore be weakest among those institutions where society would wish it to be strongest."[249]

This problem could be solved by forcing the break up of the larger banks. Alan Greenspan has proposed another solution. Although the former head of America's Federal Reserve may not have covered himself in glory for his part in the financial crisis, his idea of premium capital reserve ratios for larger banks has considerable merit. He set out his idea in an article for the *Financial Times*:

> "New regulatory challenges arise because of the recently proven fact that some financial institutions have become too big to fail as their failure would raise systemic concerns. This status gives them a highly market-distorting special competitive advantage in pricing their debt and equities. The solution is to have graduated regulatory capital requirements to discourage them from becoming too big and to offset their competitive advantage."[250]

If these super-ratios are sufficiently punitive—and I mean punitive—they could take us back to an era of smaller, less systematically-dangerous banks.

HAS BANKING CULTURE CHANGED?

If you wanted motorists to stop tailgating you could mount a spike in the centre of the car's steering wheel—directed towards the driver's breast. It's not clear which of two economics professors—Armen Alchian or Gordon Tullock—were the originators of this radical approach to road safety but you get the idea.[251] We don't want boring banks—it might be better that we get frightening banks.

The British Tory MP Steve Baker—of Cobden Partners, a specialist consultancy on banking crises—has recommended radical measures to reconnect risk and reward. His answer to Bank of England chief economist Andy Haldane's desire that we "reshape risk-taking incentives on a durable basis" is to reassert the liability of bankers.[252] He recommends unlimited personal liability for the board members of banks in the event that their institution becomes insolvent. He also recommends that bonus payments be deferred over five years—invested in escrow accounts until they are paid. Two gentlemen whose names might be familiar to you—Nathan Rothschild (1777 to 1836) and J P Morgan (1837 to 1913) operated under unlimited liability and such partnerships were not unusual—even up to the 1980s. "Banks are often quick to require

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small business directors to provide personal, secured guarantees," continued Baker, and "what is sauce for the goose is sauce for the gander."[253] Have such liability reforms been dismissed because they would produce a haemorrhage of operations from financial centres that required them? Have they been dismissed because of lobbying by crony capitalists in the banking centre? Have they been dismissed because they really are not a good idea? I fear the first two explanations are most likely.

It should, nonetheless, be noted that up to 60% of bonuses in the City of London are now being deferred for seven years for bankers who exercise significant influence functions. Since 2011 when the new regime was introduced, £900 million of bonuses have been clawed back.[254]

WILL THE NEXT EPISODE OF UK ASSET PRICE INFLATION MEET WITH A STRONGER RESPONSE FROM THE MONETARY AUTHORITIES?

For the International Monetary Fund in Washington the major policy error in the years leading to the financial crisis was not excessively lax monetary policy but the lack of an effective regulatory framework to protect financial stability. For the Bank of International Settlements in Basle the key error was low interest rates which encouraged the growth of indebtedness in the world economy and the misallocation of capital.[255] A problem we might be experiencing again now.

Jeremy Stein, a governor on the Federal Reserve Board, appears to have departed from the Greenspan-Bernanke consensus that monetary policy-makers should not concern themselves with financial stability. He joined with a number of academic commentators—who worry at the dominant role that monetary policy plays in inflating and deflating credit bubbles. In a speech in February 2013 Mr Stein worried that "if the underlying economic environment creates a strong incentive for financial institutions to, say, take on more credit risk in a reach for yield, it is unlikely that regulatory tools can completely contain this behaviour."[256] His arguments were summarised on *The Economist's* "Free Exchange" blog.[257]

Personally I think we need the monetary rather than the regulatory authorities to take the lead responsibility in avoiding the next crisis. Or at least lessening its impact—crises of some kind have always occurred and always will. The policy we need is called "leaning against the wind" and was described by Jean-Claude Trichet, the former governor of the European Central Bank:

> "The leaning against the wind principle describes a tendency to cautiously raise interest rates even beyond the level necessary to maintain price stability over the short to medium term when a potentially detrimental asset price boom is identified. It should be mentioned that leaning against the wind has the advantage that it can to some degree ameliorate the moral hazard problem of the purely reactive approach to asset price boom-bust cycles. By reacting more symmetrically—i.e. being tighter in booms as well as looser in busts—the central bank would discourage excessive risk-taking and thereby reduce over-investment already during the boom. This in turn would lead to a lower level of indebtedness and less severe consequences of a possible future bust."[258]

Leaning against the wind dampens two things that are central to crises: excessive risk-taking and asset price inflation. We operate the other way round at the moment—or at least we did in the Greenspan era. At times of fragility central banks eased monetary conditions—putting a floor under asset prices. But when confidence was high—even giddy—the monetary authorities were slow to act. Other than Jamie Caruana at the Bank for International Settlements, no senior central bankers are proponents of "leaning", however.

HAS THE HOUSING MARKET BEEN FIXED?

I have only one recommendation to add to the comments I have already made on housing throughout this paper and that is to quote the wisdom of one of the world's richest people, Warren Buffet. This is what he wrote in one of his annual letters to investors:

> "Home purchases should involve an honest-to-God down payment of at least 10 per cent and monthly payments that can be comfortably handled by the borrower's income. That income should be carefully verified. Putting people into homes, though a desirable goal, shouldn't be our country's primary objective. Keeping them in their homes should be the ambition."[259]

Seven years after the crash all sorts of phenomena that were deemed to be part of the problem are back. Telephone number salary awards for bankers. Skyscraping house price inflation. Zero deposit mortgages. And a monetary policy that accommodates asset price inflation. We haven't learnt enough lessons.

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Concluding Remarks and Acknowledgements

This paper has largely been about the free enterprise system and how it can be reformed to ensure the often unacknowledged prosperity that capitalism has helped to create can be sustained and extended. To conclude, however, I'd like to say something that some might think is tangential, subsidiary or even irrelevant but which significantly motivates why I've written this paper. The reform of capitalism is not just about economic competitiveness or social justice. It's also about restoring the place of America and its freedom-loving allies in the world. If the Anglo-Saxon, European and Japanese brands of capitalism continue to exhibit relative decline at the expense, for example, of the Chinese form of state capitalism it won't just be prosperity that will suffer. The extension of democracy, the rule of law and human rights depends upon the countries that most embody those principles being strong enough to inspire emulation from other still developing and emerging countries. Economic capability also underpins US power in international organisations, in bilateral diplomacy and in trade policy.

Adding up to a quarter of a century of decline three American presidencies in succession have to lesser or greater extents failed. Bill Clinton took a "holiday from history", dithering over the Balkans, Rwanda and the growth of al-Qaeda for example. Anti-Americanism reached new heights during the presidency of George W Bush. The mishandled Iraq war, accusations of torture and the Guantanamo Bay controversy hurt the United States' standing in the world. Then came Barack Obama's election and, for many—notably the Nobel Peace Prize committee, giddy hopes of a fresh start. The failed "reset" of relations with Russia leading to the civil war in Ukraine; the botched changes to a planned missile defence shield for Poland and the Czech Republic; the unpunished crossing of the red line use of chemical weapons by the Assad regime in Syria; the rise of ISIS in an abandoned Iraq; a controversial nuclear deal with Tehran; and the recent re-escalation of violence between Israelis and Palestinians have dashed hopes of something new.

The United States is an unhappy country at the end of the Obama years with fringe candidates like Donald Trump and Bernie Sanders reflecting the fact that two-thirds of Americans think their country is no longer heading in the right direction. The rest of the world also worries that America might be on the wrong track. The banking shocks of 2008 didn't just hurt America's economic standing but too many nations and people now wonder if America and the "American way" are the future. Few have been more explicit about this than the "illiberal" Hungarian prime minister Viktor Orbán (to use his own self-description). Speaking last year, Mr Orbán declared that "the most popular topic in thinking today is trying to understand how systems that are not Western, not liberal, not liberal democracies and perhaps not even democracies, can nevertheless make their nations successful." "The stars," he continued, "of the international analysts today are Singapore, China, India, Russia and Turkey."[260] His arguments are questionable. His list of "stars" is very questionable—while Singapore still shines brightly the others are fading fast. But with so much dysfunctionality—even gridlock—on Capitol Hill, racial tension, after three disappointing presidencies over one quarter of a century, and with so much gloom from the American people it is at least understandable that Orbán—a man who kills pigs with his own hands and turns them into sausages—is increasingly willing to turn away from the American model and to get down and dirty with the likes of Russia, China and Saudi Arabia. Many in Latin America, Africa and Asia think the same as Budapest—reorientating their policies away from Washington and its worldview. Two years ago, in a moment of candour and perhaps foolishness, even Justin Trudeau, Canada's new prime minister, identified China as the country he most admired. "There's a level of admiration I actually have for China," he said, "their basic dictatorship is actually allowing them to turn their economy around on a dime."[261]

We shouldn't exaggerate America's problems, of course. It remains the world's richest and most innovative nation. It remains the nation described by the poet Emma Lazurus in *The New Colossus.* Her words are engraved on the lower pedestal of the Statue of Liberty:

> "Give me your tired, your poor,
>
> Your huddled masses yearning to breathe free,
>
> The wretched refuse of your teeming shore.
>
> Send these, the homeless, tempest-tossed, to me:
>
> I lift my lamp beside the golden door."

For all of capitalism's troubles people are still yearning to live in the United States of America. More people are trying to leave Mexico for America than are trying to leave any other country in the world for any other. The flows from China, India and the Philippines to America are all enormous. People are also queuing up to get into Australia, Britain, Canada, Germany and, for example, New Zealand. For all of the many weaknesses in the western model of capitalism it is still a magnet for those seeking freedom, prosperity and security—for those yearning to breathe free. But millions are also migrating to the fast-growing Middle Eastern nations. Competition for talented migrants as well as for supremacy in modelling economic development and political governance is intense. History hasn't ended. Liberal democracy hasn't triumphed. Reforming our model of democratic capitalism so that it delivers prosperity for all matters and it matters in more ways than one.

ACKNOWLEDGEMENTS

As a columnist for *The Times* I'm always conscious of the danger that I rarely research a topic for more than a few days before the news agenda moves me on to the next, fresher topic. I'm grateful to the Legatum Institute and its financial supporters, therefore, for giving me the opportunity to pause and think at greater length about this great topic of the future of capitalism. I've been given complete freedom to explore the topic in my own way and have made some conclusions that some at the Legatum Institute will not endorse. At a time when activists on both the Right and the Left demand purity it has been a privilege to work for a think tank that has given me such space to think so freely. I'm especially grateful to Sian Hansen and Cristina Odone who recruited me to write this paper and to Harriet Maltby for her advice. Special mention should also go to Iain Martin and his team at the CapX.co website, Zac Tate and Rachel Cunliffe. At *CapX* I've been able to road-test much of the thinking that has gone into this report. I should also thank the British Business Secretary, Sajid Javid MP; the former leader of the Liberal Democrat party, Lord Ashdown of Norton-sub-Hamdon; and the former Chief Rabbi of the United Hebrew Congregations of the Commonwealth, Lord Sacks for accepting my invitation to set out their own thinking about the future of "democratic capitalism" at three private seminars at the Legatum Institute's London offices. Their contributions and the responses of other participants in those seminars inspired much of what I've written although, as should always be made clear, I take sole responsibility for the ideas and observations within this report.

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