Conservative Free Markets, and the Case for Real Capitalism

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- *Capitalism is the greatest tool of wealth creation, social advance and economic development ever known.*
- *But we are living through an age of crony capitalism, as illustrated by case studies of the Goldman Sachs flotation and the Lloyds-HBOS merger.*
- *The Conservative party has an honourable record of attacking corporate and financial excess.*
- *Moreover, only conservatism contains the intellectual resources required to make the case for real capitalism successfully.*
- *Conservatives must now turn up the volume, make the moral case for real capitalism, and take action against crony capitalism – and the culture that created it.*

1. The Conservative Challenge

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

This is a matter of huge public concern. But it sets free market conservatives a special quandary. It is now thirty-odd years since Mrs Thatcher's government took the momentous decisions to open up the British economy, float sterling, dismantle state subsidies, attack cartels, privatise many industries and deregulate the City of London. Are current events an indictment of that whole long arc of government? Has the Conservatives' belief in free markets been a mistake? Or is something else going on?

These questions were raised by the Labour leader, Ed Miliband, in his conference speech denouncing "predators" in business. The argument was poorly framed, and the speech largely dismissed or attacked by the press. But it was striking that Peter Oborne in the *Daily Telegraph* hailed it as an attempt to create "a new structure for British governance and public discourse." Still more tellingly, that comment itself followed an article in July 2011 entitled "I'm starting to think the Left might actually be right" in which Charles Moore, the biographer of Lady Thatcher, pointed out that the West was "bust—both actually and morally".

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Both writers pointed to the present time as a sea-change in the basic terms of British politics, and acknowledged the challenge posed to Conservatives in particular. This paper is an attempt to respond to them, and to move the debate on: to remind ourselves how we got here, to set out what I take to be the fundamental issues at stake, and finally to frame a viewpoint that addresses the needs of the age while remaining both distinctively free market, and distinctively conservative.

2. The Moral Case for Capitalism

Let us start with a simple fact: capitalism is the greatest tool of economic development, wealth creation and social advance ever known. In capitalism, owners of intellectual, financial or human capital have property rights that enable them to earn a profit as a reward for putting that capital at risk in some form of free market economic activity. Capitalism creates wealth, as witness the development of Western democracies vs. that of Communist countries after 1945. In these cases, the difference between the capitalist and the communist alternative was not a percent or two a year; per capita wealth in the capitalist economies grew by several multiples of that in their communist counterparts.

The same is true for developing countries. Korea used to be one country. Thirty years after the Korean war, GDP per capita in capitalist South Korea was five times that of communist North Korea; in 2009 it was sixteen times greater. China's economic growth only started to accelerate in the 1980s, when it opened up special economic zones and started to implement market-oriented reforms. Trade, not aid, is pulling Africa out of poverty after decades of stagnation.

Capitalism also stimulates social advance, since individual economic freedom and social freedom tend to go together. In 1688 the economic superpower in Europe was France. A hundred years later, it was Britain. Why? Because France was dominated by an autocratic Bourbon monarchy, a rigid and highly centralised bureaucracy, and a religious hierarchy that was highly intolerant of dissent. She lacked the openness, trust and free institutions to generate a large entrepreneur class and above all, she lacked credit, since the government defaulted repeatedly on its debts. When Louis XIV revoked the edict of Nantes in 1685 and banned Protestantism, the result was to send hundreds of thousands of entrepreneurial Huguenots abroad, many to Britain. The arrival of William of Orange in Britain itself released a huge wave of capitalist energy, assisted by savvy Dutch commercial skills. The combined result was to make Britain by far the most prosperous and successful nation in the world for almost two hundred years.

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

Against these attacks, some defenders of capitalism shrug their shoulders, as though to suggest that such moral evils should be tolerated because capitalism increases wealth, or because the alternatives are worse. That is a mistake; it is better to answer these charges directly. Of course abuses of capitalism often occur, as we shall see in detail. But the bigger truth is that capitalism is at root a moral force for good. It relies on, and so demands:

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

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

But there is a huge But. This is real capitalism, capitalism as it's supposed to work. That's not the capitalism we have in the UK at present. What we have now, in large parts of the UK economy, is crony capitalism. Not only that; we have failed to reflect on, let alone reach a public consensus on, the difference between real capitalism and crony capitalism, and the nature of capitalism itself. For many people capitalism has been identified with the rampant financial speculation that got us into the present mess in the first place. It has therefore come to seem both inevitable and deeply unattractive. Yet socialism and communism have failed. Thus the root cause of the current wave of huge social anger at bank bonuses and financial malpractice is precisely the fact that, however harsh and unfair capitalism may appear, no-one can articulate a remotely plausible alternative. Little wonder that protesters have occupied St Paul's for so long.

Again, the truth is very different. There are many varieties of capitalism. Without realising it the free-market West, most notably the US and the UK, has sleepwalked into a species of financial crony capitalism that has disguised economic reality, shielded underperformance, cosseted poor management and leached away value.

The effects of this were not evident during the 1990s, when growth was at a premium and the UK coasted through the NICE decade—the decade of Non-Inflationary Continuous Expansion. Now, however, we are well into the NASTY decade: Noxious Austerity Stretching Ten Years. It may not prove to be that long. But however long it is, the policy response to the UK's current economic malaise cannot simply consist of measures to restore growth and battle deflation. Rather, the goal should be to wake up and smell the coffee: to address the economic realities of the 21st century by changing some of the key features of our market economy and, especially, our culture over time.

We need, then, to do two things: to make the moral case for real capitalism, and take resolute and sustained action against crony capitalism. As we shall see, the Conservative party has an honourable record of attacking corporate and financial excess. Indeed, we can go further: the moral case for capitalism relies on a distinctively conservative understanding of capitalism and free markets; it cannot be made successfully by socialists or economic neoliberals. The only way to rehabilitate free markets is by making them more conservative.

3. Crony Capitalism

We are familiar with different models of capitalist economy, from the USA to Scandinavia to Japan. But what is crony capitalism? Like many things, it's easy to recognise but hard to define. Nevertheless, one can again identify different varieties, such as monopoly, franchise, khaki and narco-capitalism:

- *Monopoly capitalism* flourished in the USA at the end of the 19th century. At that time individuals such as Cooke, Vanderbilt and Rockefeller were able to amass enormous wealth by agglomerating new industries into "trusts", which exercised monopoly or oligopoly market power within markets.

- *Franchise capitalism* developed in Russia during the 1990s. A generation of "oligarchs" emerged, alongside the official apparatus of the state, whose wealth derived from winning lucrative natural resources franchises in oil and gas.

- *Khaki capitalism* has taken root in countries such as Egypt and Pakistan, where the armed forces have become large economic actors in their own right. In Egypt, for example, the army runs roughly 10 per cent of the economy.

- *Narco-capitalism* has been seen in recent decades in Mexico and Colombia, among other countries. The drugs trade created enormous illicit profits for its chiefs. As the trade became a substantial part of a regional or national economy, it was further entrenched through corruption.

This list is hardly exhaustive, and these varieties can and do often co-exist in a given country or society. Some, like narco-capitalism, are illegal; others may be corrupt but not actually illegal. But they all exploit the absence of law or law enforcement, market mechanisms or culture which in other times and places act as constraints on individual self-enrichment. Over time, the winners become massive interest groups in their own right, and seek to exercise influence over government in order to extract favourable regulation, subsidies, and low oversight.

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

- Business activity loses any relation to, and often clashes with, the wider public interest; and
- Business merit is separated from business reward.

These features in turn feed off and into a culture in which values of decency, modesty and respect are disregarded, and short-termism and quick returns come to dominate long-established norms of fair dealing and just reward.

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

This country is emerging from a time of fake capitalism, matched by fake government; a time when Fred Goodwin could destroy an august 200-year old financial institution and squander billions in shareholder value, then walk away with a fortune and have a government minister sign off on his pension. A time when the economy became grossly unbalanced, and executive pay soared inside and outside the financial sector, with little or no relation to performance. A time of increased complexity, short-termism, bureaucracy and regulation.

What has changed? To see this, we need to go back to an ancient principle, one that should be engraved on the walls of Parliament. *This is that the corporation or company is the creation of statute.* That is to say, corporations exist not because of any divine or natural or common law right, but because we, the people, created them through legislation enacted in Parliament. The earliest companies, such as the East India Company in 1599, were chartered directly by the sovereign for specific commercial purposes of conquest, colonisation or trade. Incorporation was a privilege that conferred economic benefits, and the purpose of the charter was to ensure that these benefits were in the sovereign’s, and later in the public, interest. Corporations and markets existed because, by statute or circumstance, they created wealth and well-being.

Over time, the privilege of incorporation has been transmuted into a legal freedom, and the link to the public interest has been all but forgotten. Vast numbers of new companies have been created, and vast numbers have failed. The legitimacy of the company as such has become a matter not of charter, but of compliance with law; ownership has become devalued, with shares seen as betting slips. Little justification for corporate activity has been sought, but where it has that justification is given through a link between public interest and shareholder returns, and latterly employment. If the shareholders are getting a return, if a company is employing people gainfully, then these alone are regarded as sufficient raison d’être. If the shareholders don’t like the business, they should sell their shares.

Crony capitalism is what happens when the constraints of law and markets and culture cease to be effective, or disappear; when entire industries lose their governing rationale; and when executives, freed from real accountability, are able to reward themselves at the expense of the shareholders. Entrepreneurship and value creation are replaced by rent-seeking, and certain groups become enormously wealthy without taking risk. These factors in turn lead to long-term economic underperformance, and sometimes to social unrest.

Seen in these terms, the financial capitalism that has grown up in the UK and the USA over the past twenty years is best understood as a further species of crony capitalism. It has much in common with the US financial capitalism of the 1920s, which culminated in the Wall Street crash of 1929. Then as now, financial institutions were able to exploit informational and risk advantages to make enormous profits during a time of massive asset inflation and lax supervision. Then as now, Wall Street—the financial sector—became separated from Main Street—the needs of business—and the public good.

4. The Case of Goldman Sachs

Take the investment bank Goldman Sachs. Goldman has become a clichéd symbol of financial excess, but it is nonetheless instructive. Few other businesses of any kind have been so consistently or massively profitable, with $20 billion in 2009 profits alone. Few other businesses have been as pious in their official pronouncements, with the very first page of Goldman's 2010 Annual Report proclaiming, as one of its core principles, that "Integrity and honesty are at the heart of everything we do."

But few other financial institutions have so seriously breached public norms of behaviour and ethics in recent years, as acknowledged by Goldman's payment in July 2010 of a record $550 million to settle an SEC court case for misleading investors over a sub-prime mortgage product. Little wonder, then, that a recently leaked HM Revenue & Customs memo described Goldman as having resisted HMRC investigation for suspected evasion of National Insurance for "five more years … raking every conceivable point in the Tribunal, and putting up a 'stooge' witness" rather than the executive actually responsible."

The ironies are manifest, for historically Goldman was famous for being risk averse, dedicated to its clients, and shy. It was a partnership, which sought wherever possible to protect the partners' capital; it made its name dealing in commercial paper, that is, the low-risk business of providing day-to-day funds for companies; it had a well-earned reputation for putting its clients' interests first, and for many years only advised for the defence on hostile takeovers; and it never courted, and rarely achieved, high media profile.

But over the past twenty years the values of risk-aversion, client focus and low profile appear to have gone by the board. During the 2000s, Goldman developed a massive proprietary trading operation. Over time this became so profitable that it dominated many aspects of the firm's trading and market-making operations. Conflicts of interest became endemic. When the subprime crisis struck, Goldman only survived by becoming a bank holding company and drawing heavily on various emergency liquidity packages provided by the US government.

The firm's flotation in 1999 made the point perfectly. Generations of Goldman partners had considered and shied away from flotation, arguing that the firm's culture derived from its partnership ethos and would be undermined by publicity and media interest, that a focus on quarterly earnings would distort the firm's priorities, and that it was not for any single group of partners to cash in for personal gain the value built up over decades by their predecessors.

But in 1999 these arguments were ignored, and the reason why is instructive. In essence, there were three elements to the decision: motive, legitimating culture and cover story.

- *Motive*: the then-new partners were arguably not less or more greedy than their predecessors. But they were more numerous. Many stood to make tens of even hundreds of millions of dollars from the flotation, and there were so many of them in number that the closeness and mutual accountability of the earlier partnership no longer held sway.

- *Legitimating culture*: the 1980s and 1990s had seen an explosion of activity in the financial markets. Within financial institutions sales, trading and fundraising in the capital markets came to dominate the traditional function of providing financial and strategic advice to companies. At the same time globalisation broke open traditional practices in the major financial centres, while proprietary trading became ever more profitable. The effect of these shifts was to create a legitimating culture in which it appeared not only permissible for the 1999 Goldman partners to sell out their inheritance, but somehow natural and right for them to do so.

- *Cover story*. Motive and legitimating culture are not enough by themselves; a cover story is also needed. In the Goldman case, the cover story was a supposed need for capital. Partners were able to argue, with lots of useful statistics, that the firm was hampered by its partnership structure, which prevented it from entering important and highly profitable markets. There had recently been a series of developing country crises, and these added useful further ammunition. Without more access to capital, it was argued, how could Goldman withstand economic shocks? The irony was that when the shock came the bank was vastly under-capitalised; it had used the new capital not to improve its financial stability, but to play the markets.

Goldman Sachs changed, then, because its internal values changed, because the culture around it changed, and because its leaders were able to use a specific cover story to achieve their goals. But we can tell a similar story about the emergence of crony capitalism in the UK, as we will see.

5. Lloyds HBOS and the UK Banks

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

The same is true with the UK banks. Again, to see what has gone wrong here, we need to look at the history. Like companies, all banks are creatures of statute and are thereby given enormous powers. The core purpose of investment banks and brokers is to make markets and to provide finance for industry by raising money from third parties. The core purpose of commercial banks is to safeguard deposits and to provide finance for industry and for mortgages through their own lending. Indeed, commercial banks have an even greater power than that: they have the power to create credit—that is, money—by expanding their balance sheets. It is not widely understood how important this power is: of the money presently in circulation in the UK economy today, three per cent takes the form of cash; 97 per cent is in credit and deposits.

This financial alchemy is an extraordinary privilege, which we as citizens and taxpayers underwrite. Bank notes are legal tender and liabilities of the sovereign ("I promise to pay the bearer"), while deposits are liabilities of banks. Yet both are treated as money. As long as the public know that their deposits can be redeemed for bank notes, there is no problem. Under these circumstances the banks can and do make money by holding assets that are riskier, longer-dated and less liquid than their liabilities. The banks' ability to function thus entirely rests on the privilege afforded by public confidence in the integrity of the system.

Over time these privileges have been buttressed by mergers, further regulation and subsidy, which have reduced competition and enormously enhanced the profitability of the UK commercial banks. In particular they have benefited from the implicit guarantee that the government will step in to protect depositors in the event of a future financial crisis. In 2011 the Vickers Commission estimated the value of this subsidy over the years 2007-9 to be "considerably over £10 billion per year", with the Bank of England's chief economist putting it at an average of £57 billion over the period.

One might have expected that these enormous privileges would have two effects. First, they would engender a sense of personal modesty and restraint on the part of bank executives, reflecting the fact that in normal times commercial banking is a long term, unflashy business of "riding the yield curve" by prudently borrowing short and lending long. Secondly, they would engender a sense of continuous commitment to funding and supporting UK industry.

But in fact neither has been the case since at least 2000. It is well known that the pay of senior commercial bankers has rocketed. *What is less well known is that direct* *lending to UK non-corporate institutions is only just over 10 per cent of total UK bank domestic lending, and 5 per cent of their total lending. Lending to financial institutions and the public sector, by contrast, is over half of UK domestic lending. Some of the latter cash is on-lent to industry. But only one-tenth of UK bank lending goes directly to real, productive companies. UK banks have some £6 trillion in total assets and liabilities; most of these represent financial institutions trading with each other.*

Again, the situation is deeply ironic. Lest we forget, two of the "big four", Lloyds and Barclays, were founded and built up by Quaker families. For many years they were run on Quaker principles, which emphasized social justice, integrity, simplicity, plain dealing and thrift: "my yea is my yea and my nay is my nay". That ethos persisted for a long time within both institutions, through numerous takeovers of failing competitors. A key reason why both banks were so successful was that their Quaker ethos and sober lending principles preserved their capital while other institutions lost their heads in speculation. Moreover, the very same Quaker principles also gave them social capital, arising originally from the bonds formed between dissenters during periods of religious persecution or adversity in the 18th and 19th centuries. Barclays was particularly successful because for many years it resisted centralisation, preferring to keep local managers relatively autonomous and close to the customer.

But today these principles appear to have gone missing. The banks do not acknowledge any moral purpose to their activities, or any privilege afforded to them by the taxpayer. Their operations, those of Barclays included, have become heavily centralised and automated, creating a monotone "computer-says-no" culture far removed from customers and highly rebarbative to them. Fee income has risen sharply, and products are increasingly complex and opaque; yet there is relatively little differentiation between them.

To see crony capitalism at close range, one need look no further than the merger between Lloyds and Halifax Bank of Scotland in 2008. Under Sir Jeremy Morse and Brian Pitman, Lloyds had been by some way the best-managed UK big bank of the previous two decades, with a remorseless focus on cost control and shareholder value. It retained a largely domestic focus; it avoided the worst of the 1990s property bust; it corrected its mistakes quickly; it bought cautiously and well; it steadily innovated on the high street.

All this patient value creation was blown away by the merger in September 2008 with HBOS. The initial deal was conducted at breakneck speed for two such large institutions, with only two weeks of formal talks before the public announcement. It hinged on a private assurance—and, it has been said, much positive encouragement—from the Prime Minister, Gordon Brown, to the Lloyds Chairman, Sir Victor Blank, to the effect that the government would waive competition requirements if Lloyds took over HBOS. Lloyds itself was advised on the deal by the investment banks Merrill Lynch, Citibank and Lazards.

But look closer. The Northern Rock crisis had occurred a full year earlier. Unlike the purchase of ABN AMRO by the Royal Bank of Scotland, therefore, this transaction took place well *after* the bank crisis had started. The value of HBOS had already fallen from £40 billion in April 2007 to £8 billion at the time of the merger. Like Northern Rock, HBOS was known in the markets to have grown its loan book very rapidly, with a heavy reliance on wholesale funding. It also had a huge network of opaque off-balance sheet deals, many of them in property. And it had a track record with the FSA: in 2004 HBOS had fired its own head of risk, Paul Moore, after he had taken concerns about the bank's risk profile and funding model to the main board, causing the FSA to investigate.

Of course later events have clouded the picture, since there was a further bail-out and then partial nationalisation. But there can be little doubt that Lloyds would have avoided the worst, as Barclays did, if the HBOS deal had not occurred; and there is every reason to think the Lloyds board should have known that a merger with HBOS would be disastrous. In the words of the *Financial Times*, "The sheer scale of losses from the toxic HBOS loan book compelled Lloyds to use the government's asset protection scheme to insure £260bn ($366bn) of toxic assets - 83 per cent of which have come from the HBOS loan book."

What has been the result? Lloyds' shareholders have been wiped out, losing an estimated 85% of the value of their shares; the worst effects will have been felt by small shareholders, who did not enjoy the offsetting value from the sale of their HBOS shares. Bank customers continue to feel the chilling effects of reduced competition on the high street. The financial advisers to Lloyds, whose due diligence on HBOS had been so catastrophically bad, likely collected fees in the hundreds of millions of pounds from the deal. Some 24,000 employees have been laid off since the merger. Incredibly, Sir Victor Blank, the architect of the transaction, was invited by the BBC to guest-edit the prestigious *Today Programme* on Radio 4 over Christmas 2011.

6. Pay

But crony capitalism is not restricted to the financial sector. It can also be found in other parts of UK PLC. Many of our largest public companies have become so complacent, unaccountable and bureaucratic that they resemble bad governments. Outwardly they tick all the governance boxes, but the reality is that their managements barely answer to anyone. Those outsiders who are supposed to act as a check on abuse and poor performance — non-executive directors, auditors, corporate pension fund trustees — lack real teeth and independence. The result is that companies are too focused on the short term and spend too much money on rewarding their executives.

A recently published paper shows the extent of the problem, as business merit has become separated from business reward—the second mark of crony capitalism. *The total remuneration of the average FTSE 100 company chief executive has risen by more than 400 per cent over the past 12 years, to £4.2 million.* Take-home pay has more than doubled to £2.5 million since 1999, moving from 47 to 88 times that of a full-time UK employee. The take-home pay of a mid-size FTSE 250 CEO has doubled to £1 million, moving from 24 to 36 times median pay. Meanwhile, average real wages stagnated over the period.

Efficient markets theory holds that pay simply reflects performance. But as regards stock market performance, this is refuted by the facts. The pay of FTSE 100 chief executives rose 13.6 per cent every year from 1999 to 2010, but the FTSE itself rose by an annual average of just 1.7 per cent. Not only that: pay continued to rise despite big falls in share prices in 2000-02 and 2007-08.

Overall, no reputable study has found a significant correlation between senior executive pay and long-term corporate performance. But one correlation is well known: the bigger the company, the bigger the pay package. This link encourages takeovers and mergers, rather than organic growth. Takeovers always benefit senior managers, win or lose: the pay of the acquiring CEO and management team goes up, while the bosses of the bought companies are protected by golden parachutes—even though the evidence is that 60 per cent of takeovers destroy economic value.

7. The UK's Real Economic Decline

So much for banks and companies. But what about the UK itself? If it's really true that parts of the economy have lost their connection with the public good, and that much of management is unaccountable, then our present bout of crony capitalism should show itself in economic underperformance. Has this really happened?

The answer is Yes. The years 1992-2008 have been widely fêted as a great story of UK economic recovery, and in particular Labour propagandists have hailed the decade 1997-2007 as a miracle of continuous growth under Gordon Brown. The truth is rather different. The UK is best compared with countries with a similar cultural, political and economic background, in particular the principal mature English speaking free-market economies of the OECD: Australia, Canada, the United States and New Zealand. *And every single one of these countries grew faster over the period 1992-2008 than the UK. The UK grew by 50%, but Canada grew by 59%, the United States by 60%, New Zealand by 62% and Australia by 73%.*

Unfortunately even this picture is too rosy. While the economy grew by around 50%, much of this growth simply occurred because there was an influx of people who enlarged the workforce, and of course also became consumers. An extra three million people found employment in Britain during this period—roughly 10% of the total workforce. Once they are factored in, it turns out that UK GDP per head in fact improved not by 50% but by 42% between 1992 and 2008. In other words, the UK's growth record was even weaker than appeared at first sight, and only just above the average 40% growth of the "sclerotic" Eurozone.

In other words our "economic miracle" was a mirage. But it was not only a mirage; it was also a distraction. The real economic story was happening elsewhere in the world, with the rise of China, India, Russia and Brazil—the BRICs—the increasing economic control of Germany over the Eurozone, and a global shift of economic power away from the US, from the West and towards emerging markets. While the UK congratulated itself on its apparent local economic success, in reality it continued to lose ground globally.

Earlier we saw how three factors had played a crucial role in the institutional decline of Goldman Sachs: motive, legitimating culture and cover story. Something very similar has been true of the UK as a whole since 2000:

- *Motive*: the Blair and Brown governments sought to dispel the idea that Labour could not be trusted with the economy. They revelled in the growth created by high public spending and easy money. They saw business as an interest group like the unions, to be manipulated, placated and brought on side through specific "deals", of which the PFI was one. For their part, bank managements were delighted to play ball, for doing so allowed them to take advantage of an asymmetry of risk and reward in which increased leverage fed through into higher pay.

- *Legitimating culture*: British officialdom and popular culture had slowly fallen under the neo-liberal idea that human beings are selfish financial automata motivated by greed and fear, and that free markets are perfectly rational, well-informed and frictionless. On this view, if people were making money, they deserved to. Indeed, what they were doing was economically and socially valuable. Much of this change in culture came from the US, where a huge host of academic and media cheerleaders had arisen around Alan Greenspan, the Chairman of the Federal Reserve. Further support came from the continuing grip of textbook economics on the minds of British officials and politicians. Ideology took the place of common sense and prudence.

- *Cover story*: in this case the cover story focused on monetary policy. The creation of the Monetary Policy Committee in 1997 had formalised the previous approach of inflation targeting. What mattered, it was argued, was the conquest of inflation, and this could be achieved through setting interest rates appropriately and managing long-term expectations. The effect of this was to rationalise away any need to control specific asset bubbles, where these did not directly feed into inflation. The problem was worsened by Gordon Brown's decision to move from RPI to CPI. CPI does not reflect housing costs, so the effect of this was to keep the rise in house prices outside the headline inflation figure.

The result was an enormous burst of borrowing and leverage, the scale of which is even now not fully appreciated. *As the Vickers Commission reports emphasized, between 1960 and 2000 the loans the banks made totalled about 20 times the amount of shareholder capital they possessed. After 2000, they started to rise vertiginously, up to nearly 50 times capital in 2007-8. When the crisis hit, the banking system was already in a desperately fragile state.*

The increase in borrowing in turn fed through into a disastrous asset bubble in housing, which all but doubled in real value over the period, and into personal debt, which soared to nearly £1.5 trillion. Where only twenty years earlier personal debt had stood at below 60% of GDP, in 2007 it was, for the first time in history, higher than Britain's entire annual economic output. Eighty per cent of that debt was secured on private property.

8. Institutions: AWOL or MIA?

Asset bubbles and economic shocks are not new to the UK, even on this scale. Historically, the British constitution in its widest sense has proven up to the task of dealing with them, in large part due to its pluralism. While politicians, parties and agendas have waxed and waned, the civil service and the great institutions in and around government have provided expertise, challenge and continuity.

But these great institutions compiled a very patchy record before the recent crisis. Crony capitalism did not emerge just because of the different factors described above. It was allowed to do so because a range of august public bodies, which could have restrained or shaped it, did not do so effectively. These include HM Treasury, the Bank of England, the FSA and the CBI.

This topic really deserves a book-length treatment, and we can only touch on aspects here. With the partial exception of the Bank of England, these institutions did not blow the whistle on the ramp-up in bank lending, or even seem to have been aware of it. When the crisis struck, there was little or no institutional memory within them of how to deal with bank failures, and retired staff from the 1990s had to be begged to return.

The close working relationships that should have existed between the supervisory authorities, and between them and the largest banks, seem to have barely existed. After 1997 the Bank of England no longer regulated the banks. It pared back the resources devoted to financial stability even as the credit crisis developed, while the FSA did not regard itself as under an obligation to monitor or regulate systemic risk at all. For its part, the Treasury had long had a strong institutional culture and a phalanx of senior officials with enormous experience at its head, such as Joel Barnett, Leo Pliatzky, Douglas Wass and William Ryrie. It was deeply embarrassed by the ERM crisis, and after the retirement of Terry Burns in 1998 it seemed to go into decline, with falling morale and departing staff. It was mainly responsible for pushing the FSA into a "light touch" supervisory regime.

These institutions can all, to greater or lesser extent, argue that the domineering personality of Gordon Brown made it all but impossible to exercise an independent voice. It is certainly true that Brown or his followers quickly rid themselves of possible sources of disagreement, such as Burns himself, Jill Rutter (Press Secretary at the Treasury) and the late Alastair Ross Goobey (Chairman of the PFI panel). But this excuse is a weak one. And whatever its force, it does not apply to their performance since 2010. *Take bank reform. It should be an acute embarrassment to all concerned that there has been no comprehensive public investigation into the failures of the banking system, bank governance and the regulators.* These failures ended up costing the

British economy hundreds of billions of pounds. By comparison the failure of BCCI in 1991—a single institution—was the subject of an official inquiry. Yet there has been an astonishing official reluctance to undertake a public review of the reasons why the crash occurred, the failures involved and the lessons learned. Phone hacking, yes; the greatest shock to the UK economy for 60 years, and arguably in modern times, no.

The excuse of Brown's bullying should also not apply to the CBI, which is not a governmental body. The CBI describes itself, in a telling phrase, as "the premier lobbying organisation for UK business." It claims to speak for about 240,000 businesses, covering a third of the UK private sector workforce. It has 230 employees, a £24 million turnover and pays its new Director-General twice as much as the Prime Minister.

But what has it actually achieved? There are signs of possible change with its new Director-General. But the CBI's recent record on key issues such as bank reform, the Private Finance Initiative and executive pay has been lamentable. On all three it has consistently taken the side of big business against the interests of its smaller members and the taxpayer, and has done so in defiance of the facts.

Take the Private Finance Initiative, for instance. Over the past 20 years it has cost the UK £20 billion more to fund projects through PFI than it would have done through the Treasury — just under ten per cent of its total cost. This is a ludicrously high premium for transferring risk to the private sector, which in effect includes a state subsidy to the banks and construction industry of billions of pounds. There has just been a devastating report into the PFI by the Treasury Select Committee. Some £200 billion of new infrastructure is up for funding over the next few years. Thousands of businesses could benefit from a leaner, less finance-driven and more flexible approach. The PFI is itself a specific subculture of crony capitalism. Yet until recently the CBI has consistently defended it. Ditto with bank reform and executive pay. One of the very first public statements of the new Director General of the Institute of Directors has been to describe current executive pay as unsustainable—a striking contrast to the CBI.

As with pay, so with expenses. Whatever the circumstances, it would be a poor analysis of crony capitalism indeed that did not acknowledge the role played in it by parliamentarians involved in the expenses scandal. For their part, too, many government quangoes have raised taking personal expenses into an art form. It was reported in August 2011, for example, that the National Policing Improvement Agency had issued taxpayer-funded credit cards were issued to 150 of its staff, who spent an annual average of more than £20,000, including on such items as lawnmowers and karaoke equipment.

9. The Politics of Crony Capitalism

At this point readers may be scratching their heads. The objection might be "Maybe all this stuff about crony capitalism is true. But if it is, isn't it the Conservatives' fault? They have always been the voice of capital, just as Labour have been the voice of labour. And it was Mrs Thatcher who deregulated the City of London in the 1980s. Our present problems spring from that decision."

This familiar line of thought seems to have inspired Ed Miliband's 2011 Labour conference speech, with its distinction between "predators" and "producers". In his words "Producers train, invest, invent, sell … Predators are just interested in the fast buck, taking what they can out of the business." So there are obvious overlaps between Mr Miliband's remarks and the present critique. Does this mean the objection is right? Is our present bout of crony capitalism a Conservative, and specifically Thatcherite, creation?

Political blame games are rarely clear and never edifying. But the answer here is fairly evidently No. First, on the facts. Crony capitalism really took root in the late 1990s, when the Bank of England ceased to be responsible for systemic risk in financial markets, the doctrine of inflation targeting was institutionalised, and the banks were allowed to ramp up borrowing. These things occurred under a Labour government, ten years after Big Bang took place. PFI was introduced under John Major, but loosened up and expanded by a factor of ten times under Messrs Blair and Brown. And it was the Blair-Brown era, not the Major years, which saw the rhetoric of limitless growth by government proclamation, including the legendary "end to boom and bust".

Secondly, on the politics. As a party, the Conservative party has always been funded by private contributions, just as Labour has been funded by the unions. But historically Conservative prime ministers have in fact had a very good record of standing against corporate and financial excess. Lord Salisbury was a devout Christian with a lifelong hostility to unbridled capitalism. Bonar Law had a well-deserved reputation for personal integrity. Stanley Baldwin gave 20 per cent of his personal wealth to the Exchequer to pay war debts, and famously criticised the press lords Rothermere and Northcliffe for exercising "power without responsibility, the prerogative of the harlot throughout the ages." Churchill exuberantly surrounded himself with dubious business friends such as Beaverbrook, and was rescued from financial disaster by Sir Ernest Cassel and Sir Henry Strakosch, but there is little evidence that he had any brief for crony capitalism. Harold Macmillan's 1938 book *The Middle Way*, deeply influenced by the financial excesses of the 1920s, was a paternalist tract that advocated a far greater role for state planning of the economy. Edward Heath described Tiny Rowland as "the unacceptable face of capitalism".

Current mythology casts Mrs Thatcher as a devil-take-the-hindmost economic libertarian. She was certainly unusual in placing vigorous economic renewal at the centre of her political persona from the outset, as the times demanded. But as regards crony capitalism she was no exception to the earlier pattern of Conservative prime ministers. She had little time for financiers in general, and saw Big Bang and the deregulation of the financial markets as a means to increase competition and end restrictive practices and cosy deals. She was intensely hostile to monopoly in any form, and attacked the management of the nationalised industries as crony capitalists of a kind: under-achieving, feather-bedded and far removed from the public good. Her mantra was that ownership—of shares, or one's own home—brought with it economic and moral benefits, and needed to be spread as widely as possible: "every earner an owner", as she put it. Christianity itself contained a moral imperative, she provocatively declared in her 1988 speech to the Church of Scotland, to work hard and use one's talents to create wealth; and wealth in turn imposed a spiritual obligation to use it properly. She would not have hesitated to attack the present crony capitalism, and in the baldest terms. *There is nothing Conservative about crony capitalism.*

10. Free Market Conservatism

But there is a deeper point. Conservatism is the product of several different interlocking traditions. At its core is a respect for what is given. In the words of Edmund Burke, it sees society as resting on a compact between past, present and future generations, grounded not in abstract ideas, but in the force of human emotional ties. These ties are mediated through institutions, as bearers of human knowledge, human emotions and allegiance, and human identity. The decline of Goldman Sachs reflects in miniature the abrogation of a Burkean compact between past, present and future, and the consequences of that abrogation. So does the Lloyds-HBOS merger.

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

Francis Fukuyama hailed the fall of communism as the end of history. But one might better say that the real battle of the 21st century will be between free market neoliberalism and free market conservatism.

The use of language here is important, and the word "liberal" is emotive enough to be used and misused across the political spectrum. But, as used here, neoliberalism represents an ideological extension—and some would say, a distortion—of the insights of classical liberalism. At root, it is utopian, arid and technocratic—a game-theoretic view in which man is understood as pure will, and freedom as the absence of constraints on that will. It rests not, as conservatism does, on potentially conflicting principles, maxims, and rules of thumb, but on ideology. The effect of all ideology on practical people is to create ignorance, by substituting adherence to a specific theory for the craft of actually deciding what to do when there is limited information available. Nothing could be further from the conservative's positive moral insistence on the contingency and fragility of circumstance, on man as a human animal and on human culture, institutions and capabilities.

Both as regards diagnosis of problems and possible solutions, free market conservatism will often overlap in places with a liberal, if not neoliberal, view of free markets. Both will be innately hostile to monopoly and state interference, for example, and supportive of competition and entrepreneurship. But the two viewpoints can also come apart, especially in their respective attitudes to human behaviour, existing practices, traditions and institutions; and in their view of how change occurs. Free market neoliberalism is memoryless, since it tends to see the world mathematically and episodically, in terms of preferences and incentives operating at a given time. Free market conservatism tends to see the world as evolving continuously and organically. Some examples illustrate the difference:

- Human behaviour: neoliberal economic theory adheres to the efficient markets hypothesis. It holds that markets tend to be efficient, and consumers as economic agents act "rationally". Free market conservatives will note the copious recent evidence that even in the aggregate, consumers are biased towards the immediate present, are more averse to loss than desirous of gain, are subject to framing effects in decision-making, and vary in their decisions as between men and women, to take just a few examples. None of these things can be readily explained within the neoliberal view.

- Institutions: take the Glass-Steagall Act, which kept commercial and investment banking separate in the USA for more than 60 years. Free market neoliberals might well see this as a huge distortion of markets, which discouraged competition, inhibited economies of scale and kept costs high in both sectors. A free market conservative would look at the different banks as institutions, and might well fear the systemic consequences of allowing risk and capital to come together on a large scale.

- Markets: free market neoliberals value markets as such. Free market conservatives look at markets as institutions, and ask in each case how they in fact work and what the point of them is. This thinking leads them, for example, to an important but under-appreciated distinction between primary markets, where goods and services are first sold, and secondary markets, where they are traded. The free market conservative will note that primary markets tend to satisfy human needs directly, whether it be for food or cars or software or insurance, while secondary markets are especially prone to speculation. So the conservative will instinctively prefer primary to secondary markets, and will want to free up the former and regulate speculation in the latter. The neoliberal has no principled means to prefer one to the other, and will be hostile to regulation in both.

As regards human behaviour, institutions and markets, then, there are crucial distinctions of emphasis and approach between these two viewpoints. These in turn have political implications. The neoliberal view will push politicians to defer more to technocrats and experts, while the conservative one demands of them a more connoisseurial understanding of institutions and human temperament. The neoliberal will rightly fret at the possible re-emergence of a Butskellite paternalism which goes easy on transparency, state subsidy and competition reform. The wise conservative free marketeer will be careful not to let the "conservative" overwhelm the "free market".

Making the case for real capitalism in these terms will inevitably involve a degree of soul-searching for Conservatives. It means distinguishing between the ideology of neoliberalism and the insights of classical liberalism that have often inspired Conservative politicians. It means insisting on the importance of free markets, entrepreneurship and competition. But it also means acknowledging that good government and values of decency, respect and long-term thinking may require restraining "animal spirits" and reshaping the laws and institutions in which markets are embedded.

Nevertheless, the emergence of crony capitalism shows why, in the coming battle between free market neoliberalism and free market conservatism, we must choose free market conservatism.

11. Lessons

In the current crisis there is no shortage of views, good and bad, as to how the economy can be improved, debt reduced and growth enhanced. But there is a shortage of worthwhile viewpoints, in part because ideology has stifled debate about what kind of capitalism we should want, and why.

This paper is really about viewpoints rather than remedies. But it has some clear implications for future policy. Here are nine:

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

In recent years the Conservative party has developed what amounts to a strong critique of crony capitalism and its effects. One thinks of the work of Iain Duncan Smith on poverty and social justice; David Cameron's anger at irresponsible marketing techniques and dodgy lobbying; George Osborne's annual tariff on non-doms, levy on banks, and progress on combatting tax evasion; the subtly punchy Vickers reforms; and the government's careful progress on replacing the Private Finance Initiative with a cheaper, more flexible and more transparent alternative.

Attacking crony capitalism is not anti-business, it is pro-business. Now is the time to turn up the volume.

Lesson 2: Culture matters.

It is a striking fact that there was no credit boom, and virtually no borrowing for consumption, in Germany during the 2000s. But internationally the biggest German banks took enormous gambles in US subprime assets, in dodgy Greek sovereign debt, in Ireland and Iceland. Why? The difference was in culture: domestically, the banks obeyed traditional German norms of thrift, caution and modesty; internationally, the norms were set by free market ideology. By contrast, the

Canadian and Australian banking systems largely escaped the financial crash because of their resilience, indeed conservatism, of their lending cultures. The Swedish bank Handelsbanken does not spend money on marketing, and deliberately sets out to have a 30-year relationship with its customers.

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

Lesson 3: Excessive pay is a serious issue.

This point follows directly from the first two. Pay is a litmus test of social norms, and excessive pay—the separation of business merit from business reward—is a hallmark of crony capitalism. It is getting something for nothing. It is generally a mark of inadequate competition. In finance, it undermines stability and destroys the economic incentive for highly talented people to go into other sectors, such as high tech manufacturing and pharmaceuticals, where their brains would make a huge difference but the short-term rewards are less. Overall, it promotes a culture of entitlement, and it sends a signal that we as a society are happy for fundamental norms of fair dealing and honest reward to be publicly undermined.

There is nothing Conservative about crony capitalism, and there is nothing specifically left wing about concern at excessive pay, in either the private or the public sector.

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

Addressing the issue of excessive pay does not mean direct caps on private sector pay, an incomes policy or similar quack remedies of socialism. It does mean a fundamental rethink of the mechanisms of corporate governance. Again, there are lots of possible approaches, from shareholder election of non-executive directors to the idea of a new Public Protagonist, able to present an independent case to shareholders on important issues of pay or strategy.

The key is to create and ensure vigorous enforcement of the trust law of ownership. A share's vote is part of its value, and enforcement action should be taken against the directors of companies and financial institutions who fail to use their votes in the long-term interest of their beneficiaries.

Corporate governance is not an alluring subject. But making more companies work slightly harder through better ownership would have a gigantic effect on Britain's competitiveness and prosperity as a nation. It would lift profitability and employment, while restraining executive pay. And even a small improvement in shareholder returns would hugely strengthen our pension system over the long term. That's a prize worth fighting for.

But good corporate governance stretches far wider than just pay. Take the current furore about press freedom; this has been cast as a binary choice between free expression and government regulation. A better way to look at it is as a problem of corporate governance. Phone hacking took place on an industrial scale in large measure because the news organisations involved were poorly governed; a key part of the solution is not so much direct regulation but better governance, against public standards defined by Parliament through legislation.

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

The UK banking system is far better capitalised than it was in 2007-8. But it remains in an extremely precarious position, as the money markets are drying up in Europe and the US.

There is thus a strong case for the banks temporarily to restrain, or perhaps cease, dividend and large bonus distributions, to protect their capital base and lending. Dividends are more problematic, since they feed into pension funds. But a cap on bonuses could be structured so as to exempt the large number of people who work in less well-paid jobs in finance. In testimony in January 2011 before the Treasury Select Committee, Barclays' boss Bob Diamond confirmed that of the bank's 150,000 employees roughly half, working in the commercial bank, would receive 6-8 per cent of the 2011 bonus pool, with an average of £2,000; the other half, working in the investment bank, would receive the remaining 92-94 per cent, or roughly £30,000 on average.

Bank bonuses should be paid not in shares, but in debt. Share bonuses tend to encourage imprudent borrowing, since in normal times the returns go straight to the bottom line, while it may take years for bad debt to appear. Bonuses in non-transferable debt would encourage the banks to preserve capital and manage risk prudently.

The banks have argued that without access to the equity markets the only way to improve capital ratios is by reducing lending. This is incorrect: a bonus and/or dividend cap would allow vital business lending to be protected.

Lesson 6: We need a fundamental rethink about competition

A sustained attack on crony capitalism demands a new and deeper look at competition, and at competition policy. In the financial sector, proactive measures should be taken to increase the very small number of mid-size banks operating in the UK, and cut implicit subsidies. There should also be a formal investigation of levels of competition in wholesale financial services such as equity underwriting, where a recent OFT study found that fees had gone up by nearly half over the past eight years.

However, there is a deeper issue to be addressed. The official view of competition is a neoliberal one based on price competition and the possibility of market failure, conceived nationally. Among other things, this means that other social goals, and regional or local priorities, tend to be disregarded. Local democracy, and a community's ability to shape its own culture, are relegated to the sidelines. Local shops are undermined by the big supermarkets, which have low prices at the till but impose significant external costs on the communities around them. Local services and small businesses lose out, although they trap more spending locally and are often more durable than the national chains.

But if culture matters, then local shops and services matter. The government's current drive for localism is a crucial step in the right direction. What we now need is a deeper look at competition policy itself.

Lesson 7: Key public institutions require better governance

Over the past decade key British institutions, notably the Bank of England, the Treasury and the FSA, did not exercise adequate financial oversight and supervision of the UK financial system. A great deal of attention has been given recently to the issue of how to reform them, and the financial regulatory system has been heavily reconfigured, with huge new powers being given to the Bank of England. But less attention has been given to the governance of the institutions themselves, new and old. This needs to change: the Bank of England's own performance before and during the crash has never been properly examined, and its failure to take action was not simply due to a lack of the right tools.

To start to address this, the Court of the Bank of England needs to become a properly functioning board with supervisory powers; the board minutes of the new Financial Conduct Authority should be published, as those of the Monetary Policy Committee are published, in order to improve transparency; and the procedures, openness and internal challenge of the Treasury's own board should be reviewed.

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

As we have seen, an important lesson of the past decade is that inflation targeting was not sufficient by itself to prevent asset bubbles; and that if inflation is stable and low the Monetary Policy Committee is not a means by which monetary policy can be used to "lean against the wind" when asset bubbles start to inflate. Moreover, when disaster struck the procedures and arrangements by which the regulatory authorities could properly and effectively intervene were almost completely absent.

It appears that the relevant emergency procedures are being established. But the Bank of England must be able to monitor areas of growth and intervene proactively where appropriate, in a way that is accountable but free of everyday political interference. Possible tools could include the ability to change loan to value ratios, margins, or capital or liquidity requirements. The effect of these is to repose yet more power in the hands of the Bank; hence the need for greater scrutiny and transparency discussed above.

Lesson 9: We need to love our savers.

Imagine you need to hire someone, and there are two candidates. All you know about them is that candidate A wanted a plasma screen TV, went out and bought it on credit, while candidate B saved £50 a week until they had enough to buy it. Which should you hire? The latter, because they have shown they care more about solvency than instant gratification, and because they have shown they have the self-discipline to save.

Saving is a virtuous habit. But it has been destroyed by the recent cycle of boom and bust. Boom, because the ramp up in easy money persuaded an entire generation that they could have what they wanted on tick. Bust, because in a cruel irony, the crash has led to low, even negative, real interest rates, destroying the savings built up over the years by millions of industrious and thrifty people.

What can be done? The banks could start by restoring the old rule that required people to save for a minimum of two years in order to get a mortgage. For its part, the government has done an excellent job of protecting pensioners, who live off their savings. Now it needs to look at ways to support current savers, perhaps by dusting off the Lifetime Savings Account or LiSA, developed by David Willetts, Greg Clark and the present author before the 2005 general election. This simple, private sector solution would tie together the ISA and new Junior ISA; but it would also attract less well-off savers who do not benefit, or benefit only slightly, from tax relief. It would sit especially well alongside the government's current plans to introduce a flat rate basic state pension.

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

ENDNOTES

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