The Risk of Freedom
briefing

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Lost Property?

In *Das Kapital* Marx analysed the epistemological defects of the capitalist economy. The world of capitalism, he believed, is a world of systematic illusions, in which people are led by fetishism and false consciousness to become the powerless victims of forces that they wrongly suppose themselves to control. Commodities, money and capital are not forces in themselves, but the image of human industry. They are like shadows projected on a screen, which distantly imitate the human realities that give rise to them but which also appear to move with a life of their own. By attributing power to money we overlook the real source of that power in the productive process; by seeing capital as a force we forget that there is no force in economic life save that which one person exerts over another.

shareholding separates ownership from control

Marx's argument may err on the side of exuberance. Nevertheless, it is undeniable that the world of finance is rife with illusions. By representing money as a thing with a life and causality of its own, these illusions conceal the real risks attached to financial dealings. Perhaps the most potent is the illusion that money, when invested, tends to grow. A fictional economy has been built on this illusion, as investors take confidence from each other's folly, pour money into whatever enterprise has been hyped on to the stockmarket screen, and lose everything when the shadow vanishes. The dot.com bubble may have been less disastrous than the South Sea Bubble. But it was caused in the same way: by the illusion that the person who controls a business has an interest in its success. Sure, the person who owns a business has such an interest: but shareholding separates ownership from control, and separates the interest of those who control a company, from the interest of those who are entitled to its profits.

One of the cases are touched on in this *Briefing* by Francis Wheen. Enron dominated the news in America, just as the case of Lord Black and Hollinger has dominated the news in Britain. More interesting than both was the case of Lloyds, the underwriting business that had been trustee not just to funds provided by the British upper class but to the British upper class itself, which incurred unlimited liability on behalf of a firm with an impregnable reputation and a cut-glass accent. A warning sign occurred, in the form of a pretentious and expensive building by Richard Rogers. But the 'names' failed to heed it, or to see that their fortunes were exposed to utter ruin by people who were entirely unaccountable for the way they made use of them.

The case illustrates the way in which risk and responsibility have been divorced: the one who risks an asset is no longer responsible for the outcome. And the pressure of globalisation has both widened the divorce between ownership and control and increased the distance between the controller and the customer. Nineteenth-century conservatives responded to their socialist critics by arguing that a private right of property is also a private duty of care. The person who owns a thing is responsible for its use, and how are you to reproduce this responsibility when ownership has been abolished or taken over by the state? The argument is powerful, and the history of socialist governments has confirmed its force.

But it seems that private property, like state property, can escape the duties and responsibilities which justify it, and so blacken its own name. Shareholders relinquish all direct responsibility for their investment, while executives recognize less and less responsibility for its use. True, there is a whitewash industry devoted to political correctness or 'corporate social responsibility'. But the real responsibilities of business — which are to provide profit to the investor and service to the customer — are routinely and costlessly evaded.

The answer, according to Wayne Boulder, is to let it all happen. The current malaise is merely one more 'crisis of capitalism', from which the system will recover in a new and strengthened form, as investors learn to read the signs and to use their money wisely. A free economy depends upon risk, and those who take the risks must pay the cost of them if they are to earn the rewards.

Our Theme

Shareholding

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Capitalism — the threat from within:

Norman Barry

The limited liability corporation was the great invention of modern capitalism. Its feature of freely tradeable shares made it a very efficient form of commercial organisation; it could raise capital easily and respond quickly to any changes in circumstances.

But there was always a problem with it, first identified by Adam Smith. By its very nature limited liability involves the separation of ownership and control. The owners, the shareholders, appoint managers to handle their assets while they draw the dividend. How do you guarantee that the managers will not shirk on the job, pocket earnings rightfully belonging to owners and act in a purely self-interested manner, like government employees? Of course, they have fiduciary duties under common law to act in the best interests of the owners; but how are these duties enforced? Smith thought that only with single proprietorship could the problem be solved.

We are seeing the conundrum in a big way with recent business scandals. In the US there have been Enron, WorldCom and Tyco, to name just three. All involved the managers fixing the share price, overpaying themselves vastly and showing a cavalier disregard for their fiduciary duties. In Enron, the managers were telling shareholders (mainly workers) to buy more stock in the company just when they knew it was about to fall in value and they had sold theirs. It should be pointed out that all those involved complied perfectly with the demands of the modern fad of business ethics: they took care of the environment, gave to charity, practised affirmative action in the workplace and built swimming pools for deprived children. But they stole from the owners.

Then there is the long-running case of Lord (Conrad) Black, former chairman of Hollinger International. After increasing doubts about his probity a committee of directors issued a damning report accusing him of looting $400m, including lavish expenditure on Lady Black's (Barbara Amiel's) handbags, from the company. Black is the leading shareholder but he does not own the company.

But clearly capitalism has to find some way of aligning the interests of owners and employees. We can see this in Britain where, although there is little evidence so far of criminality, there is much waste of shareholders' money. Lord (Arnold) Weinstock spent years carefully building up General Electric, personally checking company employees' expenses and watching every penny. On retirement he left the firm with a cash pile of well over a £1billion. His successors renamed the company Marconi, embarked on the new craze of 'telecommunications', squandered the cash, took on massive new debts and drove the share price down from £15 to 2p. The virtually bankrupt company dismissed its chief executive and finance officer but with payoffs approaching a million each. Right now, Sainsburys, the retailer, has a slumping share price and has sacked its completely ineffective, but high profile, chairman, Sir Peter Davis. He leaves with a massive reward of shares totalling £2.4million. With remuneration committees consisting of other directors it is not at all surprising the incompetent do so well.

What is required is a more active role for the shareholders in the management of quoted companies. It is absurd to suppose that Auntie Joan with her 100 or so BT or BA shares can ever be involved in the running of the company. She is so small a player it would be technically irrational for her to use her 'voice'; all she can do is 'exit'. But quoted companies are, in the main, owned by institutions which handle our insurance policies and pensions. Traditionally, they have not concerned themselves with company policy over remuneration, takeovers etc. At AGMs they vote with the directors (who can usually get their way through proxy voting, anyway) and merely keep their eyes on share prices. They shift their holdings around according to their movements.

Capitalism should reform before being crippled by regulation . . .

A form of shareholder activism is, however, the only way capitalism can reform itself. And it is beginning to happen. In America, a huge public sector pension fund, Calpers (California Public Employees Retirement System), closely monitors managements and in Britain similar movements are taking place. For example, Jean-Pierre Garnier, head of GlaxoSmithKline, had his enormous remuneration significantly reduced. But the old ways continue. Shell recently fired Sir Peter Watts, its chairman, for misleading shareholders about oil reserves. He too, left with a million.

The lesson to be learned from all this is that, if it is to survive, capitalism must reform itself — by the assertion of property rights. If there are many more scandals the erstwhile socialists, now advocates of 'civil society' and 'responsible commerce', will have a field day with crippling regulations: a much more effective way of undermining the free exchange system than nationalisation ever was.

Norman Barry is professor of political science at the University of Buckingham

Stake and Chips

Sonya Merton

Should companies be controlled by their managers or their shareholders? Neither, say the new critics of the capitalist system; companies should be controlled by their stakeholders. The critics don't mean the term in its old legal sense, of someone who holds property while its owner is being determined. They use it to mean whoever has a stake in the business, either by contributing to, or suffering from, its success. If you helped the firm to grow by working for it, then you have 'paid into' its success and are entitled to be 'paid out' from the profit. If your interests were damaged as the firm expanded then you too deserve a 'pay out' to compensate for your loss.

At first 'stakeholder' was used only to refer to those involved in the actual business of a firm: suppliers, employees, debt holders and so on. Soon it had been broadened to cover neighbours and even competitors. Now it is often used to refer to society as a whole: we all have a stake in every commercial enterprise, since we all have interests which it can advance or threaten. In this way people with chips on their shoulders can get together as 'stakeholders' and make life hell for the management and shareholders in any business whose activities they disapprove of or whose profits they covet.

Consider the Stakeholder Alliance. Its official aim is the worthy one of making corporations accountable for their actions. But its unofficial aim is to mobilize society against the corporations in pursuit of a politically correct agenda. Its alliance of '5 million' stakeholders, according to its website, includes 'workers, customers, communities, financial investors, suppliers, and the greater society'. And it declares itself to be 'confronting corporate power with stakeholder power'- in other words replacing the legal process with social confrontation, and compelling companies to override the interests of their shareholders in favour of policies selected by people who have no share in the company's real responsibilities.

The Managerial contract

Hardy Bouillon

After job cuts at KarstadtQuelle, Opel and Volkswagen, Chancellor Schroeder told the press what he thought to be the true cause of the disaster: 'blatant management failure' and 'incompetence *ad nauseam*'. The media echoed the Chancellor. Opel managers had made mistakes and should be held accountable, like entrepreneurs. But one or two years ago, when the mistakes began — mistakes which are now so obvious to politicians and the media — Mr. Schroeder sat with German top-management whenever possible, always friendly and usually in his shirt-sleeves. Unfortunately he forgot to tell them then what they should be doing. The media too was less outspoken about their prophetic gift than they are today. Too bad! They might have helped Germany escape the present economic crisis. A couple of details need to be brought to mind, however:

1. Managers might prepare for competition more or less well, and they do so on the shareholders' payroll. However, they, shareholders and the rest of us all know this will not determine the customers' future favour.

2. Managers are not entrepreneurs. They are paid on the basis of a contract. They can be fired only when they fail to deliver the expected services.

As Hayek pointed out, we can at best recognise patterns in customers' past behaviour, on the basis of which we can extrapolate to possible future patterns.

All shareholders can reasonably hope is that their managers have a 'flair' for future demands and thus build appropriate extrapolations. Nonetheless, their shares remain their own risk and nobody else's. They are the entrepreneurs not the managers.

What defines the entrepreneur is the fact that the relevant agreements into which he enters to make his profit contain no explicit promise that he will make any. His income is not fixed by human agreement, but evolves spontaneously from the market process. It is this momentous fact that puts shareholders and all other entrepreneurs in one camp and managers as well as all other employees in another. To confuse the two is to lose sight of the nature of risk and its place in a free economy.

Hardy Bouillon is director of the Center for a New Europe in Germany

Migration of Managers

Glaxo Gates

The flow of poor workers to the rich world, and of capital to the poor, capital-friendly world, was the greatest social transformation of the 21st C. A more unexpected migration, and ultimately a greater transformation, was of trustworthy managers from traditional cultures to the scandal-ridden corporations of high shareholder capitalism.

The bad news for high capitalism was that the habits of trustworthy leadership turned out to be a depletable resource; the children of trustworthy managers became either kleptocrats or uninterested in business. High shareholder capitalism had depended on habits of mind which were sustained only by more traditional ways of life.

I am proud that my work has alerted the world to the depth of the crisis that we face, and I hope that the UN Culture Change Convention (UNCCC) might start to repair 150 years depletion of humanity's most unexpected Common: traditional cultures, the hitherto ignored springs of capitalist success.

Extract from UNCCC Inaugural Address
Sikhim School of Management, Jan 2103.

The Honest Broker

Tim Congdon

Why should we have higher expectations about people in financial services — our bank managers, our life insurance salesmen and (if we are rich enough) our investment bank advisers? Should we really think differently about individuals in these occupations from the way we think about second-hand car salesmen?

The traditional pattern in Britain was for conflicts of interest to be minimized by the structure of the financial services industries. For example, investors in shares and bonds were not able to purchase them directly from the firms, so-called 'jobbers', which owned them and traded in them. Instead they had to place orders with agents 'brokers' who held no securities themselves and were acting entirely for the investors in seeking the best price and terms. The jobber / broker distinction was fundamental to the avoidance of conflicts of interest;

But, largely in conformity with American practices as financial business has been 'globalised' in the last 25 years, arrangements like the jobber / broker distinction have disappeared. Nowadays it is not only legal, but normal and acceptable procedure, for a retail investor in securities to maintain a relationship with an investment bank in which the bank buys and sells from its own holdings. In other words, when the retail investor is buying securities, the investment bank sells to him directly and tries to obtain the highest prices. Conversely, when the retail investor is a seller, the investment bank buys from him without any agent or intermediary in between, and of course tries to obtain the lowest prices.

The context of the transactions is such that the banks and their customers have a conflict of interest. This conflict is not accidental but logical and necessary, given the way that the securities industry is organised. American investment banks make a great show of their probity and honesty, but — given the structure of the industry – these are the equivalent in financial services of ridiculous peacock displays. The truth is that investment banks put themselves first and their customers second, that they care nothing for the morality of what they are doing but only for the legality. Their exploitative attitude towards their customers is inevitable because of the way they are organised. Both the Securities Exchange Commission in the USA and the Financial Services Authority in the UK supervise the activities of multi-function, severally-conflicted investment banks, and authorise them to do business. Such authorisation may be misinterpreted by gullible counter-parties as a mark of these organisations' high ethical standards. It would be better however if statements of authorisation read, 'This organisation has been authorised by the SEC (or the FSA), but it exists to serve the interests of its shareholders and management, not its customers, and it may seriously damage your wealth'.

Tim Congdon CBE is a director of Lombard Street Research.

The free market needs free thinking **Wayne Boulder**

While the practise of shareholding may open the way to abuse and fraud, what is the result? Sudden bankruptcies; loss of investor confidence; a growing suspicion of the broker and the financial advisors. Such crises of capitalism are not weaknesses but strengths: they are the way in which the system corrects itself.

The Soviet Union postponed the 'crisis of socialism', knowing that when it came there would be no means of recovery. Bankruptcy, which can be hidden in a capitalist economy for a couple of years at most, was hidden in the Soviet economy for seven decades. The collapse of the dot.com miracles is painful for those who invested. But the good thing about mistakes is that you learn from them. Stupidity ought to be punished, since that is how an economy becomes intelligent. That is the lesson of the South-Sea Bubble, Lloyds and Enron: eruptions which cleared stupidity from the system, and so improved it. If the current crisis awakens shareholders to the reality of the risk they are taking, then it will do us all good, by making risk intelligent. Shareholders will begin to notice the signs — plush offices, trendy slogans, golden handshakes, political hobnobbing — and withdraw their funds. Or if they don't, they deserve what they get.

Wayne Boulder is a financial analyst.

Enron and the new Rock 'n Roll economy

Francis Wheen

Enron's rapid expansion was made possible by the privatisation, and intemperate deregulation, of utilities all over the world; and a soaring stock-price encouraged thousands of small investors to entrust the company with their money. It was the new Elvis, the new Beatles, and the fans' swooning adulation matched that of any screaming teenybopper. The masters of the New Economy had learned from the example of those 1960s rock stars who continued to present themselves as daringly rebellious non-conformists even after acquiring country estates, Rolls-Royces, offshore tax-havens and the other trappings of traditional plutocrats: in the 1990s capitalism was the new counter-culture. Kenneth Lay, the chairman of Enron, boasted of running 'the world's coolest company' and seriously considered wrapping a gigantic pair of sunglasses around the headquarters in Houston, Texas. The mantra chanted ceaselessly in Enron's corporate literature — '*Why? Why? Why?*' — was said to be 'the chosen word of the non-conformist'. (The company even set up a website, askwhy.com, to celebrate heretical thinkers down the ages.)

Enron was indeed more like a religion than a business. Its worshippers in the press spoke of 'mission', 'vision', 'destiny' and 'faith'. Kenneth Lay, the son of a Baptist minister, was himself an active member of First United Methodist Church in Houston who summarised his credo thus: 'I believe in God and I believe in free markets'. Asked by the religious affairs correspondent of the *San Diego Union-Tribune* what Jesus would do if he were chief executive of a company that bought and sold an essential energy source he replied that Jesus 'was a freedom lover. He wanted people to have the freedom to make choices'. Deregulation, according to this reading of the Gospel, was nothing less than a spiritual imperative.

At the time of Enron's creation in the mid-1980s its business was closely supervised by government. By lobbying aggressively for liberalisation and exploiting every loophole in the law, Lay swiftly achieved an overwhelming dominance in the gas and electricity markets, with sales rising from $4.6 billion to $40.1 billion in the space of a decade. In Britain, where the Blairites had an insatiable thirst for transatlantic fads and fashions, Lay's company became a great favourite of New Labour. To the untrained eye this might seem rather strange. In 1995 Enron was named by *Multinational Monitor* as one of 'the world's ten worst corporations', and two years later it became the only company (rather than government) to be the subject of a special investigation by Amnesty International, following violent attacks by Enron's private police against poor Indian villagers who objected to a power station in Maharashtra which was polluting fisheries and depleting the local water supply. The World Bank also condemned the plant, which obliged Maharashtra to pay three times as much for its electricity as other Indian states. Worse still, until the 1997 general election Labour frontbenchers were loudly committed to saving the coal industry and opposing the Tories' 'dash for gas'. The firm hired Karl Milner, a former aide to Gordon Brown who had found more lucrative employment with the political lobbyists GJW. It also made three payments to the Labour Party totalling £27,500.

Seldom has a small investment paid bigger dividends. Three weeks after the 1998 Labour Party conference, at which Enron spent £15,000 sponsoring a 'gala' dinner, the government decided not to refer its £1.5 billion takeover of Wessex Water to the monopolies commission — thus giving the American company a monopoly of water supplies in much of south-west England. After being renamed Azurix, Wessex Water was floated on the New York stock exchange, to the great enrichment of the Enron-appointed directors, while the hapless customers endured price increases of up to 34 per cent. The new chief executive, Rebecca Mark, who had a pay-and-incentives package worth £33 million, promised that the company would soon control water supplies around the globe. (She resigned two years later, when Enron had to repurchase its stock at less than half the floatation price.)

Intensive lobbying led in 1999 to the British government relaxing its moratorium on private gas-fired power stations so that Enron could build a plant in Teesside, cancelling the ban entirely in November 2000 and giving consent to another Enron gas plant on the Isle of Grain in Kent. The New Year honours list six weeks later included a CBE for Ralph Hodge, the chairman of Enron Europe — 'for services to the power generation and gas industries'. (True he didn't get a peerage, but for a measly £27,500 you can't expect everything.)

By the following December Enron was the biggest bankruptcy in American corporate history. As they contemplated the disappearance of their life savings, many shareholders must have echoed Ken Lay's favourite question: 'Why? Why? Why?' It transpired that investment capital had appeared in the books as pure profit, while real losses were transferred to shell companies known as 'special partnerships' and thus excised from the balance-sheet. The fictional earnings kept the share-price high, which in turn enabled Enron to raise yet more investment money that could be added to the next quarter's 'profits'. The image of irresistible success had been created with smoke and mirrors.

Extract from *How Mumbo Jumbo Conquered the World*. Francis Wheen is a journalist.

In Reply: Your discussion of children did not mention the use of the addictive drug Ritalin, in order to suppress disruptive behaviour. Over 4mill. US children are on Ritalin, prescribed as a treatment for 'Attention Deficient Hyperactivity Disorder' (ADHD), itself a fabricated category meaning adult neglect. Children raised on TV, fast food and in 'child-centred' classrooms, are very likely to be out of control. To satisfy our conscience we 'treat' them with a brain-damaging drug. The Federal Department of Education then promises schools hundreds of dollars for every child 'diagnosed' with ADHD, lest anybody get hold of the idea that we, the parents and teachers, are to blame.

Cindy Delamere, Sperryville, VA

Publications / www.

Soros' Split Personality — an essay by Jeffrey A. Frankel available from http://www.foreignaffairs.org. In the guise of a review of ***The Crisis of Global Capitalism*** by George Soros, Public Affairs (1998), Frankel considers the position of Soros the investor, philanthropist and public intellectual. 'When Soros the speculator helps force a currency into crisis, what does Soros the philanthropist think about the social or moral implications for the country under attack?'

The End of Globalization: Lessons from the Great Depression by Harold James, Harvard University Press (2001). This and other financial and economic books by Harold James http://his.princeton.edu/people/e15/james/profile.html provide the historical context for understanding capitalism as a self-correcting system.

A Handbook for Shareholder Activism published electronically by **Friends of the Earth** http://www.foe.org/international/shareholder/. Strategy for shareholder influence.

Solving the pension fund crisis: how derivitives can help by Henry Kat, Cass Business School, Sept 2003 www.cass.city.ac.uk/media/stories/story_27_32695_25651.html. Looks to the flexibility of the investment process to create profit and minimise risk, thereby solving the worldwide pension fund crisis.

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