THE PROBLEM OF SHORT-TERMISM IN BRITISH INDUSTRY

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Since the 1980s, many economists have argued that British industry suffers from the problem of short-termism, that is, a reluctance to make investments which will only make profits in the long term, especially investments in research and development. They believe that this is one of the main reasons why countries like Germany and Japan have left us far behind. The subject is a controversial one, with some economists insisting that short-termism is an imaginary problem, but in the last few years two major studies have confirmed that it is real. *The Competitive Advantage of Nations* by Michael Porter (1990) compares the economies of ten leading industrial countries, including Britain. *Keeping Good Company* by Jonathan Charkham (1994) compares British methods of business management with those of France, Germany, Japan and the USA. Many of the people who recognise the problem are socialists who believe that it should be solved by state intervention. However, it should not logically be necessary for the government to force investors to act in their own interests, so if they are acting against their interests, a better course of action would be to find out if something is putting pressure on them to do so, and remove it. I would suggest, in the light of Porter and Charkham's conclusions, that the pressure comes from two main sources: taxation and takeovers.

THE EFFECTS OF TAXATION

If a company invests in research and development, the price of its shares rises in the long term because of the extra profits which they are expected to earn in the future. If capital gains are taxed, investment is discouraged. This point is emphasised by Porter, who points out that capital gains tax is higher in Britain than in any other country in his study, and in some of our competitors it does not even exist. Capital gains tax accounts for only two or three per cent of the government's revenue, and if it was abolished, the benefit to the nation through the removal of an incentive to short-termism would be far greater than the loss. However, the solution is not quite as simple as that, because of the effects of income tax.

Under the present system of taxation, shareholders pay income tax on their profits if a company distributes them as dividends, but not if it keeps them and reinvests them internally. This is supposed to encourage companies to invest in research and development, but in reality it has the effect of encouraging investment in long-established companies at the expense of newly-launched companies. Shareholders who receive dividends may not spend the money; they may choose to save it and reinvest it in another company. A system which favours existing companies at the expense of new companies must, of course, hinder competition and promote inefficiency.

If reinvested profits are exempt from income tax, and if capital gains tax does not exist (as in Britain before 1965), or if it is less than income tax (as in Britain from 1965 to 1988), then shareholders who want income for consumption will get more money if they receive it in the form of capital gains than in the form of dividends. If a company reinvests its profits, it raises the price of its shares, thus enabling investors to sell at a profit, and this profit will be higher than the dividend which they could have received if the company had distributed its earnings. However, the quickest way for a company to raise its share price is not by investing in research and development, which only increases profits in the long term, by creating new productive assets, but by spending the money on taking over other companies, which increases profits immediately by acquiring assets which are already productive. Takeovers reduce competition, and they also encourage short-termism themselves, for reasons which I will discuss later.

What all this means is that the abolition of capital gains tax alone would not be enough to remove all fiscal incentives to short-termism. It would also be necessary to reform the income tax system so that companies were required to notify shareholders of the value of all reinvested profits, and shareholders were required to pay income tax on them at the same rate as on dividends. This policy was proposed more than thirty years ago by Milton Friedman (see Friedman 1962, Chapter 8). His aim was to prevent monopoly, but its effect on short-termism would be just as important.

THE EFFECTS OF TAKEOVERS

Under the present system of company law, joint-stock companies can own shares in each other, and one company can take over another by buying shares on the market until it has a majority. This system is taken for granted by most people, including most libertarians, but it was questioned by Friedrich Hayek as long ago as 1960 in his essay "The Corporation in a Democratic Society" (reprinted in Hayek 1967, Chapter 22). He commented that:

> So far as I can discover, this was never deliberately decided upon in full awareness of all its applications, but came about simply as a result of the conception that, if legal personality was conferred upon the corporation, it was natural to confer upon it all powers which natural persons possessed.
>
> (Hayek 1967, p. 309)

He went on to point out that:

> The corporation thereby becomes, instead of an association of partners with a common interest, an association of groups whose interest may be in strong conflict.
>
> (Hayek 1967, p. 309)

He mentioned two kinds of conflict which can occur. Firstly, if Company A trades with Company B, while at the same time owning a majority stake in it, it can fix prices so that it benefits at the expense of the minority shareholders in Company B. Secondly, a minority can outvote the majority through a pyramid structure. For example, if Company A owns 51% of Company B, which in turn owns 51% of Company C, then Company A can control Company C even though it only owns 26% of it. The solution which he proposed was that companies should still be allowed to own shares in other companies as an investment, but they should not be allowed to exercise their voting rights. However, it might be simpler if companies were not allowed to own shares in each other at all. This would have the disadvantage that a company could not divide itself into several subsidiaries

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which kept separate accounts and could borrow money or make other contracts independently; it would also mean that a group of companies could not form a consortium to undertake a joint venture. To get round these problems, perhaps two kinds of company could be legally recognised: ordinary joint-stock companies, in which shares could only be held by individuals or unincorporated associations (e.g. pension funds and unit trusts), and subsidiary companies, which could only be owned by other companies.

Apart from conflicts between shareholders, company law also has implications for short-termism. In Britain (and also in the USA and other English-speaking nations), investment institutions have got into the habit of relying on takeovers or the threat of takeovers to make managers accountable to the owners of the business. If a company is inefficiently managed, investors sell their shares to a hostile bidder, or, failing that, they sell to any buyer, which reduces the price of the shares and makes a takeover bid easier. In Germany and Japan, things are different. Hostile bids are not actually impossible under German and Japanese company law, but they are rare because the investment institutions do not like them. Instead, they prefer to intervene directly in management, by using their votes at general meetings to remove bad managers and appoint their own representatives to the board of directors.

Some economists have defended the British system on the grounds that the threat of a takeover is the best possible incentive to efficient management. However, others disagree. Dick Taverne has pointed out in his article "Making Capitalism Work" (1990) that a takeover usually comes after bad management has already done its damage to the profitability of the business, but direct intervention by active shareholders can deal with the trouble before too much damage has occurred. He also comments that takeovers are always expensive because of the cost of advice on making them and resisting them. This criticism is endorsed by Jonathan Charkham, who describes takeovers as "an unnecessarily expensive and illogical solution" (Charkham 1994, p. 229), and points out that the biggest beneficiaries of a takeover battle are usually the investment banks which act as advisers. Michael Porter also calls takeovers "a second best solution" (Porter 1990, p. 661), and notes that if a company pays for a takeover with borrowed money, repayment of the debt can be a severe burden on the business.

The constant threat of takeovers leads to short-termism because managers are forced to cut investment, especially in research and development, in order to increase short-term profits and keep their share price high enough to prevent a bid. This point is emphasised by Porter. Taverne points out that they may also give up part of their market share in an attempt to get a higher rate of return from the part of the market which they keep. Takeovers also interfere with long-term planning. If managers are always looking over their shoulders, watching for the next hostile bid and planning their defences, it distracts them from looking ahead and planning the future of the company. They may devote all their efforts to safeguarding their own jobs by bidding for other companies themselves, or devising stratagems like "poison pills" and "golden parachutes", which do nothing to make a company more efficient. When companies are changing hands all the time in a never-ending game of industrial pass-the-parcel, long-term planning becomes virtually impossible because there is no continuity in management. One typical consequence has been described by Peter Thompson, the former Chairman of the National Freight Consortium:

> I was in the office of an American whose company had been taken over three times in four years. While I was there, his new boss rang him. Such was the cynicism, his reply to his secretary was "Take his name; I'll ring him back."
> (Thompson 1990, p. 169)

If company law was reformed along the lines described above, takeovers would still be possible, but only if the shareholders of the target company voted to sell all their assets to the bidder at a general meeting. Since it would be just as easy to hold a general meeting to vote an inefficient management out of office, there would be no need to resort to a takeover just to change the management. (Takeovers may, of course, be desirable for other reasons, such as creating a bigger company to achieve economies of scale.) This legal reform would force investment institutions to take a more active role in management in order to protect their profits, and it would be much quicker than relying on argument and persuasion to get them to change their habits and behave like their German and Japanese counterparts. It may be objected that removing the threat of a takeover would leave managers without any accountability at all, but if so, I do not think that state of affairs would last very long. Where there is a will, there is always a way, and where there is a lot of money at stake, there is bound to be a will. With millions of pounds at stake, investors would not be slow to find new ways of exercising their property rights. The present system is completely illogical, because it means that owners cannot control their own property except by selling it out from under the feet of the people they have put in charge of it. As Charkham says:

> To require a takeover to change a chief executive officer is like needing a revolution or foreign conquest to change a government. (Charkham 1994, p. 3)

BRITAIN'S ECONOMIC FUTURE

In this essay I have compared Britain unfavourably with Germany and Japan. Some people may think I am being unduly pessimistic, since the British economy is growing at the moment, while Germany and Japan are suffering problems. However, I do not think there is any cause for complacency. It is worth noting that Germany's gross national product is twice as big as Britain's and Japan's is four times as big — and if Britain's economic system was really superior to Germany's, we would be taking over Mercedes-Benz instead of the Germans taking over Rolls-Royce. When Germany and Japan have recovered from their present crises, we will still have a lot of catching up to do.

There were several reasons for Britain's economic decline. One of them was the restrictive practices imposed by the trade unions, which were swept away by Margaret Thatcher in the 1980s. Another, which still exists, was the snobbery described by Martin Wiener in *English Culture and the Decline of the Industrial Spirit* (1981). We chose to believe that trade was not a proper career for a true gentleman, not realising that it was trade that made Britain great. Short-termism is the final reason. If Britain is ever going to be great again, snobbery and short-termism are the problems which we will have to overcome. If we can do it, perhaps one day we will be able to buy back Rolls-Royce Motors and all the other famous British names which have fallen into foreign hands, so that we no longer have to take orders from foreigners in our own home. That is a goal worth fighting for.

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