

# SHORT-TERMISM IN BRITISH INDUSTRY: THE STATE OF THE DEBATE

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## WILL HUTTON ON SHORT-TERMISM

*The State We're In* by Will Hutton has been one of the best-selling and most controversial political books of recent years. When it was first published, in 1995, I came across it in a bookshop, but I decided not to bother reading it when I discovered that Chapter 9 was called "Why Keynesian Economics Is Best". A few years later I came across it again, in a library, and I now believe that my original judgment was not entirely fair to the author. This is not because I have changed my mind about Keynesian economics, or because I am in favour of Hutton's other pet idea, the stakeholding economy, but because I think he has some important things to say about the problem of short-termism in British industry. (Short-termism is the reluctance of companies to make investments which will only make profits in the long term, especially investments in research and development, and in the training of workers.) I am writing this essay because I want to try to salvage the long-termist baby from the bathwater of Keynesianism and stakeholding theory.

In 1997 the Institute of Economic Affairs published a book called *Stakeholding and Its Critics*, which consisted of an essay by Hutton, followed by critical comments by five other writers, and finally a rejoinder by Hutton. The most interesting comment was by Tim Congdon. It interested me because I got the impression that he and Hutton were talking past each other without actually communicating. They both accused each other of getting things back to front, but they were both half right without realising it. I now propose to explain which half is which.

## SHORT-TERMISM AND LIQUIDITY

Hutton's argument is that (a) short-termism is the problem; (b) the desire of investors for liquidity is the cause; and (c) state intervention is the solution. I believe that he is right about the problem, but wrong about the cause and the solution. He maintains that the desire for liquidity (i.e. the ability to convert investments readily into cash) leads investors to demand an excessively high rate of return in the short term. This argument has been very convincingly demolished by Congdon, who explains that it is actually the opposite of the truth. In reality, investors are always willing to accept a lower rate of return on a liquid asset than on an illiquid asset. However, this does not exclude the possibility that short-termism does exist, and is a problem, but is caused by something else. Congdon fails to make this distinction. His chapter in *Stakeholding and Its Critics* is called "How Britain Benefits from Short-Termism", but it should really have been called "How Britain Benefits from Liquid Financial Markets", because that is what he explains.

Hutton and Congdon's failure to understand each other is clearly illustrated by the case of Peter Young, which they both mention. Young was a unit trust manager who got into trouble when his trust failed to meet its liabilities to investors who wanted to exchange their units for cash. Congdon says that the case proves he is right, because Young put the investors' money into illiquid assets which he could not sell for an adequate price (Hutton, Congdon et al. 1997, p. 26). Hutton retorts that the case proves he is right, because Young was trying to make excessively high profits in the short term (pp. 90-91). If short-termism is caused by something other than the desire for liquidity, they could both be right.

## THE PERFORMANCE OF BRITISH INDUSTRY

Congdon goes on to make further criticisms of Hutton's claim that British investors demand too high a rate of return on their money. He explains that Hutton does not distinguish between the rate of return on equities and the rate of return on physical capital. The difference between them is that the rate of return on equities is just a matter of dividends, while the rate of return on physical capital includes not only dividends but reinvested profits and interest to lenders such as banks and bondholders. The rate of return on equities can also fall if the price of shares rises because of anticipated future dividends, even though the present dividend stays the same. Congdon points out that British industry has a high rate of return on equities but a low rate



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on physical capital (Hutton, Congdon et al. 1997, pp. 27-29). He also points out that investors can make more money from an expanding industry with low dividends than from a contracting industry with high dividends, because the increase in the total return more than makes up for the lower rate of return (p. 28).

In his rejoinder, Hutton implicitly accepts these criticisms, but he says that they actually support his case. He argues that British companies make their existing stock of capital work hard and deliver high productivity, which accounts for the high rate of return on equities, but they invest too little, so that their stock of capital is small and only grows slowly, which accounts for the low rate of return on physical capital (p. 90). In fact, British industry is suffering from the very problem which Congdon describes. Investors are getting high dividends from static or slowly expanding industries, when they could make more money from rapidly expanding industries which paid dividends at a lower rate.

### FOREIGN CONTROL OF BRITISH INDUSTRY

Empirically, Hutton does seem to have a lot of evidence on his side, even if some of his theoretical explanations are flawed. One important consequence of short-termism to which he draws attention is that companies from short-termist countries like Britain are often taken over by companies from long-termist countries like Germany and Japan. As he says in the second edition of *The State We're In*:

It is a strange measure of world leadership that flagship British companies like Rover, Morgan Grenfell and Kleinwort Benson should fall into German ownership rather than the other way round. (Hutton 1996, p.xvii)

The combination of short-termism and the quest for high financial returns is now rebounding on the City itself. The most spectacular recent example was the collapse of the merchant bank Barings through massive unmonitored speculation in the Far East in the search for high short-term profits; the British investment houses Warburgs, Kleinwort Benson and Smith New Court have quickly followed it into foreign ownership, unable to make the required returns upon which their impatient shareholders insist.

(Hutton 1996, p. 328)

According to one school of thought, it does not matter whether a company is British-owned or not, as long as it provides plenty of jobs. However, this is a weak argument, because experience shows that when the going gets tough, foreign companies always close their British branches before their operations in their home countries. This was illustrated very clearly by the sudden wave of factory closures which hit the electronics industry in 1998. All the companies involved were either German (Siemens), Japanese (Fujitsu), Korean (Hyundai, LG), or American (National Semiconductors, Viasystems). Of course, we should not blame foreigners for behaving like this, because we would do the same thing if we were in their shoes, but the point is that if we do not look after our national interests ourselves, we cannot expect anyone else to do it for us, and if too much of British industry is foreign-owned, it is clearly against our national interests. Banning foreign takeovers by law is a tempting solution, but in fact this would be counter-productive, because it would only deal with the symptoms of the problem. We have to tackle the cause, which is short-termism.

In *The State to Come*, the sequel to *The State We're In*, Hutton criticises Conservative Eurosceptics for their inconsistency. In his own words:

A philosophy which positively welcomes inward investment and foreign ownership of British assets — because

ownership is said not to matter — cannot at the same time damn European integration because it threatens sovereignty.

(Hutton 1997, p. 13)

He is absolutely right. Consistent patriots who want to liberate Britain from any kind of foreign control should recognise that the European Union is not the only problem. If we do not want to have to go crawling to foreign companies like BMW to beg for favours when a car factory in Birmingham is threatened with closure, we will have to make some changes here in our own country.

### A THREE-POINT PLAN TO COMBAT SHORT-TERMISM

If short-termism has got nothing to do with liquidity, then what does cause it? I believe that it has two main causes: the taxation system, and the habit of relying on takeovers to change managements. I have discussed this subject more thoroughly in my pamphlet *The Problem of Short-Termism in British Industry* (1998), so I will only summarise my arguments briefly here. In my opinion, Britain needs a three-point plan to combat short-termism, as follows:

- (a) abolish capital gains tax;
- (b) ensure that the taxation system does not discriminate between dividends and reinvested profits;
- (c) reform company law so that companies cannot buy shares in other companies.

Capital gains tax penalises investors when the price of their shares rises in anticipation of future dividends, so it deters companies from investing in research and development or anything else which will increase profits in the long term. Tax breaks on reinvested profits are supposed to encourage companies to spend the money on research and development, but in practice they are more likely to spend it on takeovers, which cause short-termism. (This policy also reduces competition by favouring existing companies at the expense of new companies.) Today everyone takes it for granted that companies can buy shares in other companies, but in fact the law only allows this because of a historical accident. If the law did not allow it, takeovers would only be possible if the shareholders in the target company held a general meeting and voted to sell all the company's assets to the bidder. Since it would be just as easy to hold a shareholders' meeting to vote a bad management out of office, there would be no reason to resort to a takeover just to replace the management.

Will Hutton is absolutely right when he says that we would all benefit if British companies invested more in research, development and training, and formed long-term relationships with their workers, bankers, suppliers and customers. However, I would like all this to be achieved by voluntary agreements between the people involved, because they perceive that it is in their best interests, rather than being forcibly imposed by the state, as stakeholding theorists believe it should be. This will only happen if taxation and company law are reformed so that companies are freed from the pressures which are driving them into short-termism.

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