Political pressure may encourage 'responsible capitalism' in the short term. But more competition and higher educational standards are needed in the long term.

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All three major party leaders have been at pains to stress their determination to nurture responsible capitalism and end the culture of economic recklessness that has dragged us into the worst crisis since the Great Depression. **Tim Leunig** *discusses the methods by which such responsibility may be achieved, arguing that long-term success will only come through greater competition in product markets, and a commitment to increasing the numbers of skilled workers in the labour force.*

Responsible capitalism is all the rage. Of course, no one was ever in favour of irresponsible capitalism, but there is a perception that capitalism has not performed as well as it should in recent years. A generation or two ago, in the years of Aneurin Bevan, Tony Benn, or François Mitterrand, a crisis of capitalism would have been seen as an opportunity for socialism, at least in Europe. With the collapse of socialist economies in Eastern Europe, and the manifest triumph of the move to capitalism in China, that option is no longer with us. Instead we try to reform capitalism in a way that makes it work for more people.

There are essentially two ways to make capitalism more responsible. The first is government intervention. It would be perfectly possible to pass laws stating a minimum to maximum ratio for pay. Of course, companies would do their best to get round such laws, for example by outsourcing all the work currently done by low-paid employees. Government can also change the law in order to change the make-up of the boards that set pay for top executives. In Norway everyone's tax return is public so you can find out exactly how much every single person earns. A government that is serious about shining light on the issue may wish to follow the Norwegian example.

But to real free marketeers there is an alternative: greater competition. As one of my former tutors, an eminent economist, once remarked: "the sight of so many of my weaker students earning so much money in finance is good evidence of monopoly power." As a rule, people who are well paid are expropriating economic rent. Very successful footballers and popstars do indeed bring pleasure to millions, but nevertheless their superstar incomes come from expropriating the economic surplus that they create. The alternative to their superstar salaries is lower prices for concerts and football matches. In a competitive sector, someone who invents something new will become rich only fleetingly. After that competition will be vigorous, prices will fall, profits will be competed away and the benefit of the new invention will go to consumers. We see this in the car industry: cars are usually better than they were a decade or two ago, but prices have not risen in real terms to any meaningful extent.

When we see bankers, hedge fund managers, and other exceptionally well paid people earning sums of money that are simply unbelievable to the vast majority of people in the country we need to ask ourselves whether these people genuinely have a skill that is unique, or whether the industry is uncompetitive. Are the charges for underwriting, hedge fund management, and investment more generally, reasonable? Why is it that consumers do not move to lower cost providers? Are British fees out of line with those that prevail in other countries? What can we do to encourage new, lower cost, entrants? Given that we know that virtually no active fund manager manages to beat the index on any risk-adjusted basis, why do people still insist on giving such a large proportion of their investment returns to a fund manager?

More generally, we have seen a big rise in the last 20 years in the ratio of the earnings of skilled people to unskilled people. This tells me, as an economist, that we have a shortage of skilled people relative to unskilled people. Here, we do need government to intervene, to increase the standards in our schools dramatically, to increase the number of people going to university, and to increase the number of people undertaking postgraduate qualifications. The reason why wages are so low for the unskilled is not simply that they are unskilled, but that there are a vast number of unskilled people. If there were fewer of them then firms would be more likely to have to compete to employ them, raising wages for the least well off.

In the short run political pressure may indeed lead to more responsible behaviour at the top. But it cannot be a substitute in the medium or long term for more effective competition in product markets, reducing the extent to which consumers are ripped off by monopolistic providers. Nor can it be a substitute for improving the standard of education so that fewer people end up with a skill set so basic as to render them unable to get a decent job at any point in our lives. Short-term gimmicks may win politicians favourable coverage in the media, but they will have little effect in changing the country we live in.

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About the author

Tim Leunig - *LSE Economic History and Chief Economist, CentreForum*
Tim Leunig is a reader in Economic History at the LSE, and specialises in 18th and 19th century economic history. He has written on history of railways, the cotton industry, the housing market, and historical quality of life measures. His most recent work is *The glamour of speed: an analysis of postwar investment in Britain's railways* in Hood, Christopher and Margetts, Helen, (eds.) Paradoxes of modernization: unintended consequences of public policy reform. Oxford University Press. He is also the Chief Economist at CentreForum.

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