British capitalism is broken. Here's how to fix it

The country is heading towards a social and economic crisis marked by desperately high levels of inequality. But it's not too late to create a fairer society in which most people flourish

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We live in a country whose banking system seven years ago was only saved by a £1tn intervention, and that remains crippled by the legacy of private debt and stunning losses. Months ago, the secession of Scotland, which threatened to break up the foundations of the state, was narrowly avoided; it remains an ongoing threat. Our share of world markets continues to shrink, and our trade deficit has climbed to unthinkable levels. Wages have fallen, in real terms, by the greatest degree in more than a century. Inequality of income and wealth have risen to desperately high levels that may soon metastasise into a serious economic and social cancer.

Yet what is most extraordinary about the present moment is that all this now seems unexceptional; our political and economic order is so thoroughly broken that many no longer find that fact worthy of notice.

The crisis goes to the very roots of how we produce and work, and how we frame the institutions that should support the lives and ambitions of millions of ordinary people. Five million wait to be housed - yet over the last generation, five million council flats have been sold and not replaced. Millions of workers struggle in a harsh demimonde of temporary jobs and zero-hours contracts. For many, it is no longer a realisable aim to acquire skills or a profession and pursue a stable career with an enduring and reliable organisation; our companies indulge in unending cycles of restructuring, regrading, and reshaping, while the public sector has been shrunk to an unprecedented degree. It is only those at the very top who see their pay and possibilities expanding - along with the ease of passing on advantages to their children, creating a new closed caste of elites and diminishing prospects for social mobility. If we wish to create an economy, and a society, in which the majority of us flourish, Britain in 2015 is not the model to follow.

But for all the egregious mistakes made on its behalf, the country is not a wasteland: there are successes on which a different government and a new policy agenda could build. Young people are more entrepreneurial. There are clusters of new hi-tech companies. Some of our great companies are trying to be more purposeful in their business strategies, and demonstrating a commitment to innovation and high performance – judged by criteria other than rising share prices. There are great universities sponsoring frontier research of global significance. There is a willingness to embrace the new: the possibilities of the internet are more quickly seized in Britain than almost any other leading industrialised country. If our people were allowed to capitalise on today’s enormous possibilities – which would require a rediscovery of national purpose, and reconfigured institutions to match – Britain could quickly turn itself around.

The problems in the British economy and society run deep. Put at its rawest, our private institutions do not provide sufficient public good to justify their unreformed autonomy. A democracy has both the right and the duty to ask tough questions of the effectiveness of all its institutions, public and private. To insist that private institutions can only be reformed if they provenly fail – as the current centre-right consensus insists – and that public institutions must, as far as possible, simulate private ones, is to accept that the only good order is private.

If there are no networks of reciprocal obligation, and no acknowledgement that human beings associate in a society they can construct, redesign and reform around those principles, then we are all reduced to atomistic consumers and workers – serfs who are no more than notations in the spreadsheets of companies and public bodies alike. Business, too, is part of this framework. Wealth generation is not some magic left to firms and individuals in their low-taxed private garden: it reflects how companies are owned, financed and incentivised within a framework of public law – and thus what risks are run and what innovation and investment is undertaken. Business is healthier in a healthier society: it cannot be blind to social obligations. There is of necessity an inter-relationship with the democratic state. Without this recognition politicians are turned into journeymen with no great purpose, and into the vacuum pour nationalists, populists and the weird. We can do better.

The aim of any manifesto for change must be to create the smartest economy for Britain – it is the only route to prosperity in the decades ahead. But a smart economy does not stand alone, independent from the society of which it is necessarily part. It cannot be constructed without enfranchised citizens, intelligent, risk-taking consumers and equally intelligent, reflexive, creative employees. They are the investors, workers and consumers in the better-owned, better-financed and more innovative enterprises that need to be at the core of a great economy. Our capacity to move forward depends on each others’ capacities as never before: our interests are interdependent. The smart economy and smart society are two sides of the same coin – and smart societies are impossible to create without fairness, justice and enfranchisement. These great values are not merely nice to have: they are the cornerstone of the good economy and society, and it is around them that a manifesto for reform must be organised.

What follows are proposals for deep change in the way wealth generation is approached, beginning with substantive reforms in the ways companies are owned and financed. The starting point is to ensure the foundation of any capitalist economy - the company - works as it should, and that legally, constitutionally and culturally, companies are purposed to do what they can do so well. To argue for the reform of capitalist enterprise should not be interpreted as "anti-business"; rather it is to be anti-dysfunctional business. For at their best, companies are organisations of genius, solving problems, innovating and delivering great goods and services. They should not be allowed to degrade into instruments of stock market speculation, so that managers are governed by the new god - the share price - and the temptations of their own colossal self-enrichment. Yet that is what has happened for a generation.

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Twenty years ago, Britain's greatest industrial companies were the chemicals giant ICI and the electronics conglomerate GEC. Rolls-Royce, by contrast, was secured from hostile takeover by a golden share agreement that allowed the government to override other shareholders and block an unwanted bid. It had a board that was committed to research and development and to investing in its business. ICI and GEC, under colossal pressure from footloose shareholders to deliver high short-term profits, tried to wheel and deal their way to success. They did not have owners concerned to promote their competitiveness and long-term value: they were chips in the portfolios of global asset managers who had no constitutional, legal or cultural obligation towards them. They were ownerless corporations. Their great German rivals, BASF and Siemens - securely owned by long-term investors - took the Rolls-Royce route. Today Siemens is Europe's largest engineering company, BASF the world's largest chemical company. Their British rivals have literally disappeared. Rolls-Royce, free from concerns about hourly movements in its share price, has gone on to be one of our last remaining great industrial companies.

Britain has far too few firms like Rolls-Royce. Yet criticism of the ownership and financial system that produces such devastating failure has been trivial. Over the last decade, a fifth of quoted companies have evaporated from the London Stock Exchange, the largest cull in our history. Since 2004, £440bn worth of British companies have been sold overseas. Virtually no new risk capital is sought from the stock market - which has become more a vehicle for getting money out of companies than putting it in. Britain has no indigenous quoted company in the car, chemical, glass, industrial gases, industrial services and building materials industries - to name but a few. They are all owned overseas, with their research and development and strategic direction travelling abroad as well.

The stock market is ever more a casino. Now 72% of stock market trading is done by hedge funds, high-frequency traders or investment banks trading their own accounts. This business is served by a vast industry of intermediaries - agents, trustees, investment managers, registrars and advisers of all sorts - who have grown fat from opaque fees. The entire apparatus has become a mechanism to drive highly short-term expectations of profit into the boardroom, and into executives' assessments of what investments should be authorised.

This, the business line goes, is the only route to prosperity. The wider results speak otherwise. Consider the pressures that forced Tesco to massage its profits by £250m and mistreat its suppliers, or led BP to cut corners in its drilling in the Gulf of Mexico, costing billions from the consequent oil spill. Or the scale-up crisis, in which so few dynamic British startups scale up to maturity, due to a financial system that forces many founders to sell out to others before their turnover has broached £2m. All attest to deep-set failures in our corporate and financial organisation.

No reimagining of contemporary British capitalism is possible without the reimagination of how companies are owned. Companies are, after all, the central economic actors in the market economy – the investors, the innovators and employers. They give any capitalism its particular character and dynamic. Britain's increasingly divided society and the character of its labour market, with the emergence of so many contingent low-wage jobs, is inextricably intertwined with how its companies behave. So is the weakness of exports, investment and innovation.

My contention is that limited-liability companies, having certain formal privileges and status, should not be the private playthings of transient owners interested only in their own immediate self-enrichment, without any concern for how their profits are made. They should be organisational structures that allow humanity to innovate and then produce to meet the great challenges of any era: in this context profits are made by delivering a noble, moral business purpose, integral to the wider legitimacy of the enterprise. Companies should be seen as the vehicle for the marshalling and stewarding of human, physical and knowledge assets in the service of humankind. It is for that reason society offers them privileges. It is not unreasonable to want to see the terms of the bargain reciprocated; indeed it lies at the heart of a just relationship between business and society.

The cornerstone of a new approach to ownership should be a Companies Act for the 21st century. Unlike the existing act, passed in 2006, this would set out unambiguously what society expects from companies in exchange for the privileges they are afforded. The aim is to create purposeful companies with a more just relationship between themselves and the wider society, capable of fostering the trust relationships that are at the heart of high-innovation and high-performance workplaces. Companies would be required to declare their business purpose on incorporation: they should incorporate to deliver particular goods and services that serve a societal or economic need and will need particular capabilities and skills. It is through delivery of their purpose that they should seek to make profits. Most great companies have this purpose at their heart already, even if informally. Unilever famously exists to make the best everyday things for everyday folk – Boeing to build planes that fly furthest safest. This should become the rule, not the exception.

The objective is to put business purpose at the heart of every enterprise and make it something for which directors are held to account – to create a societal obligation to match the privileges of incorporation. This will not be a weaselly commitment to "have regard to" the delivery of business purpose, echoing section 172 of the current Companies Act. It should be a statutory obligation. Directors will have to produce an annual account of their stewardship of the company, of which today's financial reporting will be but one element. There will also be an account of investment, innovation, research and development, human capital development, pay scales, executive pay in relation to median pay and supply-chain relations, along with an account of the company's wider commitments on the environment and bribery.

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Investors will thus buy shares in purposed companies, reflecting a new compact between the company and its shareholders. The asset-management industry has quadrupled in size over the last 30 years, so that roughly 40% of the shares of British companies are now held overseas, typically by a global asset-management group: British pension funds own a mere 5.1% of all shares and British insurance companies 8.6%.

No UK government can reform the global asset-management industry unilaterally, but it can frame the terms on which British shares are owned. It can demand, for example, that all investors in British companies sign and comply with a tougher stewardship code, which currently sets out milk-and-water obligations to monitor investee companies, exercise votes, steward companies and act with other investors if necessary. It is better than nothing, but essentially minimalist. The code should be greatly strengthened. It should insist on total transparency on strategies, costs, leverage and trading.

The proposed new Companies Act would set out a new legal framework that will privilege long-term, engaged investment. Mutuals should be created to aggregate proxy votes, and cast them on behalf of shareholders. The basic voting share will continue as now, but it will attract more votes the longer it is held; if shares are lent, voting rights will be forgone. This will strike many in London as going too far – a dagger at the heart of British capitalism. But when Google floated, its founders Sergey Brin and Larry Page issued two classes of shares, with class A shares having 10 times more votes than class B – so Brin and Page ended up with 37.6% of the votes for 3.7% of the shares. As they said in the letter accompanying the initial public offering, "we have set up a corporate structure that will make it much harder for outside parties to take over or influence Google. This structure will also make it easier for our management team to follow the long-term, innovative approach." Ten years on from the flotation, who can say they were wrong?

LinkedIn offered its original long-term shareholders 10 times the votes when it floated in 2011, and the Glazers floated Manchester United in New York rather than London because American rules allowed the family shares to have 10 times as many votes. Owners in mainland Europe – from the Wallenbergs in Sweden, who have holdings in most of Sweden's top companies, to the Piëch family, part-owners of Porsche – use similar devices. Where there is business success and innovation, look for non-British corporate structures.

This trinity – business purpose, trusteeship and a range of committed shareholders – will be the foundation for the creation of purposeful companies, freed to behave like long-term trusts rather than dance to the tune of peripatetic day traders. They will be value creators rather than rent extractors. It would be stakeholder capitalism in practice.

These proposals must be supported by a new takeover regime. The argument in hostile takeovers should not just be over price: it should be whether business purpose is being protected – with both sides being required to ask their shareholders' view – and long-term shareholders' votes privileged over those who have bought for a quick buck. The government should refer bids that create public-interest concerns and use the Competition and Markets Authority more aggressively. In short, takeovers, especially hostile takeovers, should be the exception rather than the rule of British business life.

Britain can then go on to build a web of supporting policies similarly to reform other kinds of ownership. This would deliver better stewardship, more engagement and creativity. The more diversity, the better – from the ownership of football clubs to that of medium-sized companies. We need to reverse the steady drift to a monoculture of public companies and instead create a richer ecology within which many forms and types of ownership can flourish. Mutuals should be better protected; forms of employee share ownership promoted, company founders better allowed to retain control and the template created for public-benefit companies – from the media to the utilities – who for an explicit, undeviating declaration of public purpose can expect reciprocal privileges. There is even a case – whisper it softly – for outright public ownership of companies if they are natural monopolies.

The Shareholder Executive that holds public shareholdings before their inevitable sell-off should instead become the foundation of a British sovereign wealth fund – symbolic of a purposeful, value creating, long-term British capitalism. It should work alongside a revived Industrial and Commercial Finance Corporation, that for decades worked well as a provider of equity and debt to small and medium-sized business – taking risks its commercial bank owners would not take themselves. The very proposition is of course far-fetched – but that fact shows just how far Britain must travel if it is ever to become a more productive and innovative economy, which builds companies with real scale and impact.

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All this needs to be undergirded by a financial system designed to support business growth, innovation and investment. The central pivot of this relationship is the Bank of

England. The way it banks to the banking system, the privileges it affords when it supplies liquidity - cash - and the reciprocal demands it makes on the banks dictate the financial system's incentives and momentum. The good news is that the Bank of England, whose balance sheet after the financial crisis is now bigger in relation to GDP than it was during the second world war, has firmly got the message that its former laissez-faire approach was wrong. Under governor Mark Carney, it has begun to reassemble an interventionist arsenal matching other leading central banks. It should use it.

The task is to move the financial system away from its fixation with property lending and on to a new basis in which it supports more innovation and business investment. The Bank of England must reorganise official support so that banks know that their lending to encourage innovation will be looked upon kindly. There needs to be a vast extension of the way public guarantees and private insurance are available to relieve some of the risk in lending to support innovation. Innovation and intangible assets must become as attractive as collateral as bricks and mortar. The tax system needs to be neutral between loan finance and selling shares.

Britain must then exploit this new architecture to trigger an innovation revolution. Innovation is the transcendent driver of economic growth. The reinvention of how and what we do increases productivity, transforms the productive base and continually reframes how we work and live with reimagined goods and services. It happens best in open societies that invest in the creation and free diffusion of knowledge where the new is a matter of celebration. But there is a second reality. Innovation is risky, and it needs paying for. Many more innovations fail than succeed.

The neoliberal doctrine is that innovation will happen if there is no state involvement and if it is left to individuals having lightbulb moments, taking risks in free markets in the pursuit of bonanza profits. The number of general-purpose technologies - the generic technologies, such as steam or electricity, that change the world - will double in the 21st century, presenting enormous opportunities for innovation. But all such technologies in the past 500 years have one way or another been triggered by the state, with entrepreneurs and companies following on. The risk and the financial consequence of potential failure is beyond any one company or any single venture capitalist to bear, which is why, contrary to the avalanche of praise for individual risk-taking, in reality business and banks do not take much risk. Instead the job of frontier, game-changing innovation is, one way or another, catalysed by the state.

This is the opportunity for a national declaration of purpose, initiated by the state but working closely in an open relationship with business, finance and our world-class universities. Britain should become the world's leading hub for open innovation, a magnet for scientific endeavour worldwide and a creator of public knowledge. We already have the capability, with sufficient new investment, to be the global health hub in fields ranging from antibiotics to new gene technologies and regenerative medicine.

We could also be the master co-innovator in big data, and the world centre for the co-creation of new materials. We should aim to be a leader in the green, sustainable and energy revolutions and to be at the forefront of global aviation and space technology. All this is within our grasp.

In 1980 Britain was one of the most R&D-intensive countries in the world: now it is one of the least. We are outspent by the US, Germany, France and Japan. Any innovation revolution must see a reversal of this trend. The paucity of the business response to a British invention such as graphene – a revolutionary new carbon material developed at the University of Manchester – underlines the hollowing out of the country’s indigenous industrial and R&D base, along with the capability to capitalise upon invention, over the last 30 years. Britain has taken out just over 100 patents on graphene use; the US 1,700 and China 2,200. It is the combination – repurposed companies, reframed finance and an enabling state committed to innovation – that will redress this failure.

There needs to be a revolution in intellectual property law to encourage more sharing of copyrights and patents. Universities need to be more liberal about sharing their research. Companies need to commit to open innovation. An Innovation Bank should underwrite innovation risk. The government should double its R&D spend to £16bn to trigger an accompanying rise in business R&D. Overall R&D spending should rise from the current level of 1.7% of GDP – below the EU average – to around 3%. The government should make further frontier investments, say, in the eight great technologies identified by former innovation minister David Willetts. This should not be a stream of one-way grants and tax reliefs. It has to be a continuing, jointly created effort in the name of a great national goal.

This matrix of policies will transform Britain’s capacity for genuine wealth generation, but they must be supported by policy on two more major dimensions. Firstly the social settlement must be reshaped to 21st-century conditions, recognising that in a fast-moving economy jobs will both be created and lost quickly, but respecting enduring values of social solidarity. Employers may need to move quickly and without penalty to adjust the size of their workforces downwards; reciprocally workers need a guarantee of skills and income between periods of employment. The trade union, the cornerstone of worker voice, participation and representation, has to be reinvented and relegitimised to rebalance the new brutalities of our labour market – to become a countervailing force to those generating ever higher levels of income inequality.

Unions need to become more like guilds – guarantors of skills and fair wages – than confrontational representatives of a shrinking working class. They should pioneer profit-sharing and employee share ownership schemes, be trusted advisers on pensions and skills, and partners with enterprise represented on remuneration committees and boards as trustees of company purpose. Thinking about a renewed social contract should be generous. It is not only about workplace organisation, fair wages and access to assets; it also encompasses housing, health, pensions, public transport, education, training, and access to art, culture and sport. The story has been one of shrinkage, privatisation and displacement of risk from the state and large organisations on to the individual. Year by year the effects often go unnoticed. Cumulatively the impact is shocking.

Secondly, there can no re-energising of Britain without a complete makeover of the state. It has to change from being a directive sovereign over us to a co-creator with us. Top-down directives and control from Westminster and Whitehall never did work well, but they work even less well today. The state will continue to strategise and enable, but it will have to work through revitalised or newly invented social and public institutions that fire up the networks and occupy the territory between the state and the individual. Crucially the state will have to devolve power to city and local government where this co-creation can be done more effectively, but it must also open itself up at all levels so its decision making becomes more iterative and deliberative. Indeed, unless Britain becomes more federal in structure, conceding proper self-government to Scotland and reconfiguring key institutions like the House of Lords and the Treasury, the legitimacy and capability of the state will diminish.

Ideology, blind faith and an overpowerful Ministry for Book-keeping – aka the Treasury – have been governing Britain. The country needs more innovation, enlarged opportunity, a step change in the quality and quantity of its public infrastructure, higher-quality education, a housing revolution and a new social settlement. These are indispensable preconditions for any mass flourishing and countering inequality – and a means of propelling the economy forward in the wake of a financial crisis whose depressive legacy will be felt for more years yet. Yes, the public deficit must be lowered, but within a larger and balanced programme of national renewal: taxes must rise substantially in the next parliament – the price tag for putting justice, equity, opportunity and wider economic wellbeing on our list of national objectives. Living within our means should not mean abandoning our civilisation or devastating public capacity to improve the lot of our citizens. The creation of a more federal Britain, devolving tax-raising powers, will entail the recasting and diminution of the Treasury. It is long overdue.

Britain could and should become an exemplar of the good economy and society. The best in British business and finance, officialdom, unions, media and academia know that the old model is bust and Britain has to strike out anew. It is the great Enlightenment values – openness, daring to embrace the new, justice, equity, liberty – that should animate this emerging coalition’s ambition, rather than any hankering for economic and social transformation around traditional left-of-centre preoccupations.

The current national conversation is hardly conducive to the development of the ideas outlined here. The political right, which could adopt much of it, is transfixed by delusions of a libertarian future in a country they say they are going to reclaim from Europe. That is both their diagnosis and their solution – which in the terms of the arguments presented here are beside the point. Labour? It is in transition. It knows the socialism it used to champion no longer functions: it knows neoliberalism does not work either. It experimented with Blairism, which for all its electoral success did not address the fundamental weaknesses in the British system. It knows it is a party for the mass of Britain, with roots that must remain in the workplace and the day-to-day life of ordinary people. It is dedicated to their flourishing, and to the justice that must underpin it. The country at different times in its history has looked to its left and right traditions to do the correct thing. It now needs Labour to complete its transition, to pick up this programme, or something like it, and implement the change we need to show how good we can be. •

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