THE RETURN OF CAPITAL?
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**Disclaimer**

This publication is intended to contribute to the current debate around 'the future of capitalism'. It reflects the views of the author, and is not necessarily representative of the views either of the individual directors of Panahpur, or Panahpur corporately.

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**Cartoons/Other Drawings:**

- Page 7: Machine-breakers or ‘Luddites’, 1812
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- Page 12: $54 Trillion Public Debt around the World
  - Map created by Benjamin D. Herren, Saissi Research Group, University of Sheffield
  - Source: [http://www.viewsoftheworld.net/?p=1766](http://www.viewsoftheworld.net/?p=1766)
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- Page 27: ‘Tax office crackdown on shadow economy’ by Nicholas Cartoon

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**CONCLUSION**

- What are financial markets and how do they work?
- An overview of the different kinds of financial investments, and how a rehabilitated ‘social’ capital is starting to establish a parallel landscape
- Brief explanation of two fundamental issues for an investor to consider
- How the current regulatory regime, designed to protect the citizen, has unintentionally helped create the conditions for their powerlessness
- Why do we need a market?
- Why is there so much disharmony in society about spending money for social outcomes?
- How is government starting to adapt in light of the changing capital context?
- Can business do anything to become a better member of society in light of increasing antipathy from the public?
- How can charity do more in a context of growing social distress?
- If ambitions for the public sector are to be realised, and if business and finance are to be rehabilitated – and if the machine of the markets is to be put to work for all of society – then a number of barriers must be removed and a set of key principles adopted. Ten principles are outlined here.
INTRODUCTION

"What you have become is the price you paid to get what you used to want" - Mignon McLaughlin, The Neurontics Notebook, 1960

Twenty years after the fall of the iron curtain and the near-universal adoption of capitalism, the markets led us to the brink of disaster. Taxpayers are effectively being forced to pay for the preceding years of value extraction by the elites of the financial services and corporate sectors, and their own unwitting participation in a government debt Ponzi scheme. The financial costs are still being calculated, and the social consequences can only as yet be guessed at.

Yet markets are merely a tool, a machine – albeit a machine of great power. At their simplest, markets chew through information and motivation, and then spew out the distillation of the intelligence and will of the participants.

Modern markets have been put to work to allocate capital which evolved to have exclusively financial goals. The collective intelligence and will of the participants (led by financial services and corporate elites) appears to have settled on an allocation strategy of ‘self-enrichment now, consequences for others later’. This is a logical progression when financial services and corporate sectors, and their own unwitting participation in government debt Ponzi schemes. The financial costs are still being calculated, and the social consequences can only as yet be guessed at.

The question to which we must now address ourselves is whether it is possible to rehabilitate capital as a positive social force, as something which seeks a ‘good’ outcome for all? Can the awesome power of the markets be harnessed to allocate resources to reflect all of our needs, rather than just the financial goals of those who are operating that capital?

As social institutions, such as the family, have become less important as units of production, other institutions – government, business and charities – have grown. All use money – both a store of financial capital and a mechanism for its exchange – as the currency that enables people, organisations and governments to cooperate in the creation of social goods. They operate this capital in the context of a globalised financial services industry efficient at allocating savings and capital. But not all of them operate their capital through markets. Mostly they do so in isolation from one another, pulling in different directions, dis-aligned.

To understand whether capital can be rehabilitated as a positive social force, it is necessary to re-examine the social contract between the state, business, charities and individuals.

Our societies are coming from a strong position. The benefits enjoyed by their citizens include a high quality of life, good access to social services, the rule of law, the right to free expression, freedom of movement and association, a liberal economy, and a pluralistic liberal democracy. They are organised around the modern institutions of government, business and charity, which evolved in the 20th century – institutions that are showing cracks from sustained pressure caused by this dis-alignment. They have adopted different primary roles, and have different access to capital to fulfil these roles.

Government, using taxation revenues, has assumed the role as main provider of such social goods as healthcare, education and welfare support. Business has become pre-occupied by the narrow goal of delivering financial returns for shareholders. Charities address a range of social concerns and reach out to those whose needs are not met by either government or business, without having a reliable source of capital.

It is not sustainable for these different forces to continue to pull in different directions. Government is becoming unable to honour the social contract based on the post-war settlement of a welfare society. In the near-term, the pressure comes from the size of public debts and fiscal deficits in light of the financial crisis. In the longer term, pressure will come from ageing populations, the high cost of family failure, and competition from emerging economies with a different social contract. Charities, which lack adequate access to capital, are unable to fill the gap left behind. Business avoids any direct responsibility to society. In Capital Markets, fiduciary duty has evolved into the perceived obligation to pursue financial return to the exclusion of other considerations.

Responsibility for social outcomes has been ‘outsourced’ to government, to whom businesses have agreed to pay such taxes as their often complex company structures and global locations require.

These dis-alignments have profound negative consequences for society – especially for the vulnerable, such as children and the poor. Many needs go unmet, while innovative and effective prevention is underfunded.

In developed economies, increasingly strident demands are being made by protesters, civil society groups and media to reconnect ‘our money with our meaning’. It is clear that government, business and charity must re-think their roles for the future in light of the likely inability of governments to continue to fund welfare interventions to the level and in the way carried out in the post-World War Two era. Despite various attempts to control them, these demands are also being made in emerging economies, as nations experiencing increasing wealth and/or a communications revolution amongst their citizens consider how they are to deal with the poorer in their societies, so as to prevent instability.

It is evident that the establishments of both liberal democracies and emerging economies must be willing to re-think the social contract if they are to avoid the possibility of change being imposed upon them. If it were possible to reclaim capital as a positive social force, then might it be possible for the power of the markets to be harnessed for the benefit of all in society?

1By 2050 there will be twice as many over 65s as today. In 2008, there were 3.2 people of working age for every person of pensionable age.
2The UK is 53% funded by public sector. Source: HM Treasury, Public Spending on Health, 2008
3By 2030 there will be three times as many elderly people as there are children. www.ukcpi.org.uk
4See, for example, Sinking and Swimming; Understanding Britain’s Unmet Needs, The Young Foundation 2009
**The Past**

“Thus, cases of injustice, and oppression, and tyranny, and the most extravagant bigotry, are in constant occurrence among us every day. It is the custom to trumpet forth much wonder and astonishment at the chief actors therein setting at defiance so completely the opinion of the world; but there is no greater fallacy; it is precisely because they do consult the opinion of their own little world that such things take place at all, and strike the great world dumb with amazement.”

- A reflection on Sir Mulberry Hawk, a ‘systematic and calculating man of dissipation’, Charles Dickens in Nicholas Nickleby

If capital is to be re-aligned in our society, a perspective is required on how the ‘little worlds’ of dis-aligned interests have come about. What follows is necessarily a broad brush and generalised account. It shows that dis-alignment is neither necessary nor inevitable. Rather it is the unintended consequence of an unplanned evolution, shaped by a range of social, economic and technological changes.

**The Birth of Capital**

For centuries capital was not much more complex than land, livestock and tradable precious metals such as gold. Capital was stewarded by an all-powerful owner, a system which sometimes benefited the people (as in the case of King Arthur) and sometimes failed to benefit the people (as in the case of the Sherriff of Nottingham).

Banking developed in tandem with trade, and grew to meet the borrowing requirements of the ‘warfare state’ and then, more recently, the welfare state. The Industrial Revolution marked a critical change in the relationship between capital and business. In 1779 Ned Ludd lost his temper near Leicester and smashed two knitting frames. This sparked a movement of organised frame-breaking, which sought to hold back the tide of ‘capital’ becoming more sophisticated and abstract.

In the case of knitting frames, these were machines that enabled their owner to make more money by employing fewer people, and resulted in fundamental changes to people’s way of life that many found unwelcome. Socialism and Marxism sought a realignment of labour, capital and government in response.

Yet the Luddites were part of a broader exploration that lasted the whole of the nineteenth century and occurred in parallel to the development of a financially driven capitalism that exploited capital for the narrow financial benefits of its owners. This exploration saw numerous experiments in how more abstract and sophisticated capital, and capital instruments, might be best stewarded for all. Explorers of these ideas included the great Quaker entrepreneurs, such as Joseph Rowntree, Jesse Boot, Jeremiah Coleman, Sir Titus Salt and George Cadbury. These entrepreneurs sought to create holistic businesses which combined social responsibility to employees and communities with wealth creation. Barclays and Lloyds Banks were both Quaker-founded businesses, who had at their heart the desire to improve access to fair finance for broader sections of society.

These ideas were being explored beyond the Society of Friends. All private businesses were to a large extent created in the image of their founders. The degree to which these businesses took responsibility for the welfare of employees and the broader community reflected the variety of people owning and operating them. This remains true today, where just under half 6 of the UK workforce works for its 4.3 million small to medium sized enterprises (with 0-49 employees). C.Hoare and Co is a bank that has been exploring questions of stewardship since they started to trade at the sign of the Golden Bottle in 1673. They, and much of the UK’s privately owned SME sector, continue to explore them today.

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5 Niall Ferguson’s The Cash Nexus (Allen Lane, 2001) provides a historical account of the rise of government debt. Philip Bobbitt’s Shield of Achilles (Alfred Knopf, 2002) traces the evolution of the state from warfare to welfare state, and then to market state.

6 46.8%: Federation of Small Businesses quoting Eurostat 2003

7 See ‘Enlightened Entrepreneurs’ by Ian Bradley, Lion Hudson 1987 and 2007
Co-operatives, Industrial and Provident Societies, Savings Associations, Mutuals and other social businesses and social business structures were created out of this exploration into how capital might best be put to use to benefit society as a whole – in a way that accommodated the needy, vulnerable and excluded within it.

During the Industrial Revolution, speculations such as the South Sea Bubble and some rail investments illustrated the potential for capital to become polarised by exclusively chasing higher financial returns, and separated from tangible assets. But it was not until the 20th Century that capital became systematically polarised and separated. Now, capital will tend to either be invested to extract financial returns (business) or to be spent to achieve a social outcome (government or charity). It is often abstracted – sliced and diced so many times that only a computer knows what it owns at any point in time.

**CAPITAL LOST: SEPARATING BUSINESS FROM SOCIAL OUTCOMES**

Businesses use of capital to improve the social conditions of their employees involved a degree of paternalism. Paternalism is inevitably somewhat arbitrary, with some masters having a good understanding of the needs of their employees, and others having a more tenuous understanding. Of course many masters did not take a paternalistic approach in the first place.

The rise of the post-war social contract increasingly sought to remove such uncertainty, seeing improvements in social conditions as rights that government should meet. Increased mobility of labour, with fewer large employers employing people for their entire careers also changed the dynamic of social responsibility. This change to the social contract enabled business to believe that responsibility for welfare and positive social outcomes had been “outsourced” to the state, to whom it paid taxes. The second half of the 20th century saw businesses evolve to focus single-mindedly on delivering financial return for shareholders. Milton Friedman famously wrote an essay in the New York Times in 1970 entitled ‘The Social Responsibility of Business is to Increase its Profits’. The argument that financial value for shareholders was the sole responsibility of businesses became a universally accepted orthodoxy in capital markets. Importantly, it informed the modern understanding of fiduciary duty, the duties of anyone entrusted with managing assets on behalf of someone else – such as a charitable or pension fund beneficiary. This is important because over one quarter of global assets under management are overseen by pension fund trustees.

The perception developed that it is illegal for those operating capital for these social purposes (pension funds, charity) to invest it for anything other than maximum financial return – regardless of the social consequences of doing so. The investment guidance given to trustees, such as the Charity Commission’s CC14 guidance, even came to reflect this perception. This particular mis-perception was corrected in 2011 with the publication of revised CC14 guidance which described mixed-purpose or program-related investment as valid investments for charities.

1. TheCityUK estimated that total assets under global fund management industry of $105 trillion in 2009, with just under $28 trillion being pension funds (www.thecityuk.com/assets/uploads/fund-management-2010.pdf)

**THE LIMITS OF LIABILITY**

The issue of liability of both business and government hinders alignment. For capital invested in business, the invention of the limited liability company in 1855 established the conditions for both the global mobility of capital and the pursuit of return without responsibility.

The extension of the social contract in 1945, where government took more responsibility for welfare services, enabled business, the other major operator of capital in society, to avoid any direct social responsibility; and instead concentrate exclusively on maximising profits.

The Beveridge Report set out a plan to tackle the ‘Five Giants’ of Want; Disease; Squalor; Ignorance; and Idleness. Detailed questions of what the state provides were never agreed. Instead, the right to be spared from these social evils evolved. Logically, these rights were translated into practice through the provision of services. Restrictions to these services were never agreed as part of the extension of the Social Contract. By the 1960’s, the whistle was being blown on the unlimited liability that had been taken on by the state, by none other than the Secretary of State for Health and Social Security, Richard Crossman.

By never being defined, and hence constrained, state responsibility for the delivery of rights potentially becomes an unlimited liability. In 1948, for example, the NHS budget was £9 billion (at today’s value). In 2011/12 it will be £106 billion.

So government may be destined to break its part of the social contract. When is education, healthcare or assistance for the unemployed ever going to be good enough?

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1. There is no foreseeable limit on the social services which the nation can reasonably require except the limit that the government imposes”, Paying for Social Services, 1969, p-10
2. The NHS: http://www.nhs.uk/NHSEngland/about/Pages/overview.aspx
MONOPOLIES

Mo-nop-o-ly (noun): Exclusive control of a commodity or service in a particular market. Society has determined that monopolies are undesirable. They operate as vested interests serving themselves, without proper accountability. Yet, from the perspective of capital provision, most capital in a modern welfare economy is operated from a monopoly position.

The state invests for social outcomes. No other capital pays for the delivery of social services such as the education service, the NHS, and so on. Therefore, the state operates as a monopoly funder.

All publicly-owned businesses are owned by private capital which has aligned together in marketplaces to seek exclusively financial return. Therefore, capital operated through markets, aggregated together, acts as a monopoly. If one seeks to raise significant sums of money, it is the only supplier. The entire market works within the orthodoxy that financial return is the only criterion by which decisions can be made.

Therefore, our society has a monopoly funder seeking profit on the one hand, and a monopoly funder seeking social outcomes on the other. Both profit and social outcomes are desirable. But it is unlikely that one will have more than a passing interest in how it affects the other if they both operate in isolation of one another, in silos.

This can cause them to destroy value for one another. On the one hand, investment capital can leave behind a devalued social landscape as it focuses exclusively on extracting financial value. This can increase the need for state spending. On the other hand, the market distortion caused by state provision excludes almost all private capital from the provision of social services. By being excluded from this major part of the economy, private capital is forced to sweat the remaining areas of the economy hard – so hard that they risk collapsing under the burden.

Because of this fundamental dis-alignment, where private capital does contract with government to deliver social services, the two parties pull in different directions. Government spending seeks exclusively social outcomes, whilst the private capital seeks exclusively financial outcomes. This is the narrative that underpins the experiences of the Private Finance Initiative (PFI) in the UK in the 2000s. Therefore, a new government will find itself surrounded by self-serving, unaccountable vested interests – whether in financial markets or social service monopolies. As satirised in Yes, Minister, and (possibly) recently experienced by Steve Hilton, the monopoly position of government departments can result in politicians having the illusion of power, without a genuine ability to effect change.

SHORT SELLING THE SOCIAL CONTRACT

As government struggles to meet its unlimited liabilities under the 1945 social contract, and the social service monopolies require ever more funding, the state comes under pressure to spend more. This has led successive governments to borrow. The effective nationalisation in 2008 of the out-of-control risks taken by banks has led to concerns amongst lenders over the service-ability of sovereign debt across the globe. This has resulted in a third participant, with a significant and exclusively financial interest, to become party to the social contract – this new party is, ironically enough, banks and other financial institutions. In addition to citizens and their governments, the social contract also now de facto involves financial markets.

As long as governments and their citizens have been judged as a good credit risk, financial markets have remained benign. But as the credit worthiness of governments has looked less sure, financial markets have legitimately started to seek reassurances – and conditions to be met – in return for the continued provision of finance.

Should markets take the view that the social contract amongst welfare societies is unsustainable – that future tax revenues from aging populations and declining numbers of taxpayers will be insufficient to pay for both the social services promised by government under the social contract as well as debt servicing costs – then they might ‘short the social contract’. In essence, they may refuse to lend to support the provision of social services.

This has already started to happen, and is resulting in the need for a recalibration of the social contract. Public debate on this subject has been limited. This could be partly due to the constraints placed on it by the way in which our current political establishment has evolved. For more on this, please see later under ‘UK Political Context’.
Data Sources: Compiled from IMF, World Economic Outlook Database 04/211, with additional data from IMF and EUROSTAT.
Map created by Benjamin D. Hennig, Saissi Research Group, University of Sheffield.

$54 Trillion Public Debt around the World

Reference Map: GDP Output 2011
Mr Micawber was waiting for me within the gate, and we went up to his room (top storey but one), and cried very much. He solemnly conjured me, I remember, to take warning by his fate; and to observe that if a man had twenty pounds a-year for his income, and spent nineteen pounds nineteen shillings and sixpence, he would be happy, but that if he spent twenty pounds and one he would be miserable. After which he borrowed a shilling of me for porter, gave me a written order on Mrs Micawber for the amount, and put away his pocket-handkerchief, and cheered up.”

David Copperfield visits Mr Micawber in Kings Bench Prison in the Borough, where he has been sent for unpaid debts (Charles Dickens)

Government and capital markets have become inter-dependent: banks have depended on governments during the recent crisis, while indebted governments rely on the willingness of financial institutions to hold government bonds. For anyone who cares about social outcomes, it is impossible to ignore the social consequences of investing trillions of pounds for profit (as business does) whilst simultaneously spending billions of pounds to achieve social goals (as government does).

The illustration 'Capital Deployments in UK Society' (below) shows the scale of different capital deployments in our society. The largest section is private investment capital – £3.9 trillion of assets are deployed in our society to extract profit. The second largest section, £691 billion, is annual government spending, spent annually in our society to deliver social outcomes such as health and education. The third, £23 billion, is the amount of money spent each year on charitable interventions.
FINANCIAL INVESTMENT

Markets are an efficient means of allocating resources. The Charity Sector likes to talk about ‘crowd intelligence’ or ‘crowd funding’, but this is simply alternative language to describe a market.

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At its most simple, the complex machine on Wall Street and the City of London does nothing other than allocate resources. It is not rocket science. Financial markets operate exactly as other markets, with buyers (investors) and sellers (issuers of claims) haggling over the quality of goods and the price to be paid. Financial markets therefore all ultimately look the same.

How Capital Markets Work

Investors have capital to invest and go to the market to source investment opportunities that will meet their goals. They work through advisors, who understand them, their needs and the marketplace, and are able to advise on what investment opportunities will best meet their needs.

Issuers need capital to achieve their plans, so go to market to raise it. They, too, work through advisors who understand them and their needs, and are able to advise on where in the marketplace to find the capital that is most aligned to the characteristics of their offer. Exchanges are where the buying and selling actually occur. There are a variety of different exchanges for different kinds of investment.

There are two key points to be borne in mind when considering how, from a wider social perspective, modern financial markets operate.

The first is that nowhere are non-financial objectives or outcomes assessed or priced. Social costs, also known as ‘negative externalities’, are instead theoretically managed through regulation, such as food safety regulation. This results in a system where the only outcome priced and valued in financial markets is financial.

The second and associated point is that the outcomes achieved by the chunk of gross national income spent by government every year (45% in 2010) to create social value
At the low risk end of the spectrum is ‘senior debt’, with roughly £100 billion of term senior unsecured debt issued in 2010. This is usually a time-bound, cashflow supported claim which ranks ahead of any other claim. The price of the money (interest rate) will reflect the lower risk and senior position, and so be lower cost to the issuer and lower return to the investor. It is worthy of note that the world financial crisis has been caused mostly by investments from elsewhere on the spectrum being marketed, rated, priced and sold as senior debt when they do not, in reality, have the cashflows and security that they purported to have. Much of the current acrimony over the credit rating given to nations can be explained by the need for ratings agencies to recover some credibility following the subprime debacle.

Venturesome have arguably been operating this kind of debt for years to charities and social businesses. In 2012, Scope is issuing a bond, arranged through Investing for Good. This is deliberately designed to be a ‘vanilla’ bond product, and is an early example of an attempt to use a standard debt instrument for a rehabilitated kind of capital – capital which seeks to be a positive social force whilst also earning a financial return. This is an area of perceived opportunity for rehabilitated capital in an environment where ‘zombie’ banks charge high margins for relatively low added value as a response to their historic derivative losses.

Moving through the spectrum from right to left, from senior debt is listed investments, whether they be debt (bonds) or equities (ownership shares in companies). Because these are listed on public markets, there is good liquidity, which means that they can be easily sold and converted into cash, and are subjected to high levels of scrutiny from the markets. The total amount of new money (equity and fixed interest) raised on the London Stock Exchange in 2011 was £375 billion. In February 2012,
Mark Zuckerberg sought to position Facebook as a positive social business in his pre-IPO letter. The capital being invested at a valuation of $100 billion based on an enterprise with revenues of less than $4 billion is unlikely to have much room for social objectives whilst it seeks the revenues from Facebook to justify such a valuation. Generally, quoted equities on global financial markets are not social businesses, and are beyond the reach of an early-stage asset class. SRI (Socially Responsible Investments) funds have developed in response to a level of market demand, but these typically are more interested in negatively screening ‘sin’ stocks, rather than positively putting the capital to work for an integrated financial and social purpose. Increasingly ‘positive’ funds are in development, such as the Q Portfolio, managed by King and Shaxson, which seeks to invest capital positively in ‘socially directed’ or ‘solutions based’ investments in addition to traditional SRI stocks.

The forthcoming launch of a Social Stock Exchange in early 2013 in London on a Recognised Investment Exchange (RIE) platform is a major step towards opening up this part of the landscape to social capital.

Private Equity and Venture Capital buy particular companies (or significant stakes in companies) and then work actively with that company to improve its performance. Companies may raise new money to start up, expand, replace existing capital, enable management buy-ins or buy-outs, or be part of a process of turning round companies in trouble. A Fund Manager, someone with a track record in making successful investments, will devise an investment strategy which they believe can achieve the objectives of investors. This Fund Manager will then create a fund, which issues claims to investors. Investors invest to own a portion of this fund, which then – under the management of the Fund Manager – finds and completes investments in companies which meet the criteria of the agreed Investment Strategy. The Fund Manager then works with the company to increase its value before selling it to a targeted group of potential buyers. Private Equity Funds tend to be less risky than Venture Capital, buying major stakes in established companies. Venture Capital Funds are riskier, as they typically buy businesses which are either less mature or failing to create value for investors. This means that there is a relatively high fail rate. The successes need to pay for not only the failures, but also the costs of running the fund and the returns to investors. Therefore whilst Venture Funds are potentially higher returning, they do tend to operate under significant pressure which tends to make them aggressive. Some Private Equity and Venture Funds are listed on an exchange, to give investors liquidity – which means that they can convert their shares in the fund to cash at any time at a value that depends on the funds’ performance and perceived prospects at that point in time. The British Venture Capital Association reports that £8.24 billion was invested in UK companies in 201010. This has been a natural core area for social investment, as they have sought to foster the development of social businesses. Big Issue Invest and Bridges Ventures have led the way in the UK, with many funds being established throughout the world11.

Angel Investors operate a bit like Venture Capitalists, with the key difference that they use their own capital rather than that of others. Angel investors are usually people who have been successful in business – the ‘Dragons’ in the Dragons Den are, in investment terminology, ‘Angels’. Angels typically make smaller investments and will manage the investments themselves. This makes them higher risk, as typically business angels have less experience and are less able to aggregate their investments. It also means that Angel Investors can make decisions that go beyond the purely commercial, and make decisions based on their personal values or priorities. There is little robust data on the size of this market but NESTA quote survey estimates of £1 billion annually by 200012.

The early stage of many social businesses makes this a natural area of focus for the emerging social investment industry. Funds such as the Social Impact Co-Investment Fund managed by Finance South East and Resonance, which matches angel investments into social businesses, are starting to emerge. ClearlySo helps early stage social businesses raise angel funding. Subsidized efforts to help abound, such as UnLtd, the Big Venture Challenge (Big Lottery) and Deloitre’s Social Entrepreneur Challenge.

Family and Friends are those who will invest in something when no-one else will. They do so often without proper investment rigour and objectivity, and so often without a realistic expectation of making a return. We estimate the annual value of this financing at around £225 million per annum13. Again, because of the early stage of so many social businesses, this is an area that has got support from the social investment community through investment in ‘crowdfunding’ platforms such as Buzzbnk.com.

The role of Big Society Capital, established in 2011 using £400m of money from dormant bank accounts and £200m from Project Merlin (a deal between the UK government and certain major retail banks), is to stimulate capital flows of social investment capital, which seeks a social as well as financial outcome, across this landscape. This would explain why one of its first major investments, alongside Panahpur, was into the Social Stock Exchange.

All these ‘social businesses’ operate at some point on the below spectrum, taken from ‘Financing Civil Society’ (Venturesome, September 2008, which also includes definitions of the characteristics of these entities).

10 Table 4, BCVS Private Equity and Venture Capital Report on Investment Activity 2010, admin.bvca.co.uk/library/documents/ RIA_2010.pdf
11 See ImpactBase, hosted by the Global Impact Investors Network (thegiin), which is a database of ‘impact fund managers’.
Aggregation and Asset Allocation

All investors will tend to aggregate investments – this means, hold a basket of different claims to avoid putting all their eggs in one basket. This is also the motivation behind asset allocation. Different kinds of assets have different characteristics. Often, when one asset is doing well, another might do poorly. For example, when oil prices rise, oil companies might do well whilst car manufacturers might do badly. An asset allocated portfolio is one where investors will hold a diverse range of claims so as to 'balance' the portfolio where possible.

KL Felicitas, a US-based foundation seeking to operate all of their capital to reflect their social purposes, have pioneered the concept of aggregating and asset allocating their social investments – but this is inevitably highly challenging in such an embryonic market.

Regulation

Capital markets have recently seemed to be becoming our masters rather than our servants. That it is necessary to explain the fundamentals of capital markets that affect us all is a reflection of the degree to which our society has become separated into those who understand modern capital and those who do not. This is not sustainable, and has – at least to some degree – been caused by rules designed to protect us.

FINANCIAL PROMOTIONS REGULATION

This separation is not an accident – it has been achieved through the design of the Financial Promotions regulations. These make it illegal for anyone to promote a financial investment to a member of the public without first having been cleared by the Financial Services Authority (FSA). Financial Promotions legislation is designed to protect ignorant investors from falling prey to conmen. The requirements that must be met before an investment can be sold to a member of the public are therefore highly stringent. They require the intermediary to meet ‘capital adequacy requirements’ – having significant cash reserves (essentially ‘being rich’) – and they involve completing a high level of independent scrutiny for each specific promotion by legal and financial professionals. These cost hundreds of thousands of pounds.

These efforts to protect the man-in-the-street have had a critical unintended consequence: they have distanced the world of ‘financial promotions’ (or ‘investment’) from ordinary people by inserting a professional class of ‘intermediaries’ between them and their capital.

It is not feasible or economic to raise relatively small sums of money from the public. The only cost effective financial promotions become large promotions (multiples of millions of pounds). Therefore the regulation creates a market distortion, which results in what is commonly described as a ‘missing middle’ between early stage finance provided by family and friends, and investment finance provided within the Financial Promotions legislation.

The only capital provider in this missing middle are venture capitalists, whose business models and incentives push them to a more rapacious orientation, which makes it effectively impossible for anything other than purely financial objectives in emerging businesses to survive.

Within all of this is an implicit conflict of interest in the intermediary sector. Intermediaries are legally obliged to represent the interests of investors, and can face criminal prosecution if they fail to do so. This threat results in a focus on perception, and introduces a strong incentive to conform rather than stand out. There is safety in numbers, and this results in the much analysed herd behaviour in regulated financial markets – which ironically heightens risk for investors by creating bubbles such as the sub-prime debt bubble of the 2000s.

Compounding this is the fact that the intermediaries earn fees from their work. The more complex that investments become, then the more reliant the investor becomes on the intermediary - and so the higher the fee revenue that can be charged.

Legislators have inadvertently added to this dynamic, with their constant efforts to add to protections to investors in light of experience, which leads to ever more complexity in the financial promotions rules. This has the effect of introducing the need for ever more cost and technical expertise to navigate them.

All this has served to create a ‘priesthood’ of financial and legal professionals who act as gatekeepers to investment, with the result that the man-in-the-street becomes ever more distanced from increasingly complex investments, with the effect that he becomes ever more reliant on this priesthood.

A call for increased regulation has been a natural response to the fear and uncertainty created by the financial crisis of 2007-2012. Better regulation is clearly needed. But if it has the effect of further alienating the general population from the world of capital, it will be counter-productive. Instead, regulation needs to adopt the democratisation of finance as a core goal. Regulation has the potential to enhance, rather than constrain, the ability of the man in the street to understand and operate his own capital, by taking decisions about what is done with his savings and pension fund.

GENERAL REGULATION OF BUSINESS

Business has only been able to ‘outsource’ its social responsibilities to government in exchange for paying taxes, and in exchange for obeying regulations.

This arrangement sets the interests of business and government at odds. Government seeks to tax more and regulate more (so as to cause business to discharge a greater social responsibility) whilst Business seeks to pay less tax and enjoy fewer regulations, so as to return more money to shareholders. This leads to a game of regulatory cat and mouse.

This occurs on the design level through the practices of modern lobbying, described by David Cameron in February 2010 as ‘the next big scandal waiting to happen … an issue that exposes the far-too-cosy relationship between politics, government, business and money’. It also occurs on the implementation level through the regulators on the one hand, and the lawyers representing private and commercial interest that challenge those regulators on the other.
Market Role

Financial markets perform a range of vital functions that can be summarised as the wisdom of the crowds. Markets are the most efficient and extensive means that we have to source and assess information and evidence, and then to act on that information and evidence in whichever way that might maximise the chances of a successful outcome.

SOCIAL SPENDING

By operating in isolation of each other, the three key operators of capital in society – Business, Government and Charity – have created a system of dis-aligned interests which compete with, rather than complement, one another:

Whilst the majority of their activities take place in isolation of one another – with perhaps a culture of suspicion and cynicism about the other – when their activities do overlap, the dis-alignments become clear. Where government and business overlap, controversies rage – over the reciprocal social obligations taken on by the banking sector in return for state support, the use of Private Finance Initiatives to fund public initiatives\(^22\) and tax evasion by corporations\(^23\). There is sufficient disharmony to sustain two trade press publications – Third Sector and Social Enterprise Live – on the topic of government contracting with the charity sector. Corporate Social Responsibility (CSR) is widely seen as ‘window dressing’\(^24\). These are symptoms. The causes are in many ways simpler. In terms of quantity of money spent for social purpose, government swamps the rest. Charitable and business contributions are important, but they are dwarfed by government spending:

\(^22\) Between 1997 and 2009, 101 of the 135 new NHS hospitals built were paid for under PFI. The cost of finance is more expensive than government borrowing, and many of the contracts are now seen as inflexible and expensive. See, for example, Professor Allyson Pollock’s argument that ‘ring-fencing of private finance initiative payments prioritises investor returns over patient care’. Private Finance Initiative During NHS Austerity, British Medical Journal 2011, www.bmj.com/content/342/bmj.d324

\(^23\) While HMRC recognise a tax gap of around £40 billion, campaigners such as Tax Justice Network claim the true figure is nearer £120 billion (www.taxresearch.org.uk/documents/taxgapresponse.pdf)

Government
For many years, there has been a cross-party appetite amongst politicians to involve other capital to invest alongside government for social outcomes. The establishment of Big Society Capital in 2011 was the culmination of work by both major parties over many years. An institution with a balance sheet of over £600m was created with the purpose of stimulating the creation of a marketplace where others would invest alongside government for social outcomes. The concept of the Social Impact Bond and emerging potential of ‘Payment-by-Results’ have transcended the political divides.

Politicians appear to have collectively reached the conclusion that the state will be hampered in its ability to spend for social outcomes for the foreseeable future, and so it is in the interests of society to see others, social investors, step up to fill the gap left behind.

These social investors will only operate in any material way if they can do so in collaboration with government. Competing with, or operating in isolation of, state spending would be futile given a context where government – to a considerable extent is the market – or at least is the customer.

Yet any investor – whether they be a social or a purely financial investor – can only invest where there is a reliable counter-party. If there is reason to believe that the counter-party may be unreliable, then investors cannot invest – many will have a fiduciary duty not to.

Government has, since 1945, operated as a monopoly interest. It has been the dominant funder and has therefore enjoyed the privileged and protected position that this entails. This has resulted in the emergence of a culture and set of behavioural norms within government which make change exceptionally challenging.

This cultural barrier is compounded by the sheer size and scale of state-owned welfare monopolies. As NHS publicity states, “the NHS is one of the largest employers in the world, along with the Chinese People’s Liberation Army, the Indian Railways and the Wal-Mart supermarket chain”. Regardless of the superb things that they may be capable of, such large institutions funded by a single funder inevitably suffer from institutionalisation, inefficiencies and an inability to interface on a human level.

Markets – whether they be financial or social investment – cannot align with closed institutions of this nature. To do so introduces uncertainty and risk. An example was the government’s early review of the Feed-in-Tariff, described by the High Court in December 2011 and the Court of Appeal in January 2012 as ‘legally flawed’. By changing the rules when their own commercial projections proved to be inaccurate, the government deliberately destroyed value for investors in an effort to save itself. Any counter-party who shows a willingness to renege on terms offered in light of greater-than-expected demand is impossible to deal with.

If interests are to become aligned, and capital is to be rehabilitated, then politicians must find a way to achieve behaviour and culture change in government.

Business
The dominant goal of publicly owned business is to maximise profits. It therefore seeks to minimise costs, such as employment costs (wages, but also any ‘social benefits’), tax and input costs (energy, materials). Wherever possible, it seeks to externalise costs – for example, where the costs of clearing up litter originating from a fast food outlet are borne by government.

Discussions abound about different ideological approaches to business, such as Marjorie Kelly’s excellent Divine Right of Capital. They propose numerous ideas such as the enforced costing of negative externalities onto company books. The public debate, alas, is a long way from this territory.

The current friction point is, perhaps unsurprisingly, at the hard interface of business and government – taxes paid by corporations. The modern social contract is built on the idea that business can ‘outsource’ social responsibilities to government in return for paying their taxes. Yet as financial markets have continued to evolve and globalise, the game of cat and mouse between the tax accountants and Her Majesties Revenue and Customs (HMRC) has become increasingly sophisticated, and increasingly difficult for the HMRC to win.

There is a growing sense that business is breaking the social contract by failing to pay taxes. Demonstrators have made this point to Barclays, who paid £113m in UK corporation tax in 2009 whilst reporting over £11.6bn in profits. The deal struck by Vodafone with HMRC in 2010 which allegedly cost the public purse billions of pounds is just one of a plethora of further examples of this dis-alignment of interests between government and business.

6 Marjorie Kelly, The Divine Right of Capital: Dethroning the Corporate Aristocracy, Berrett-Koehler 2001
7 http://www.guardian.co.uk/money/2011/dec/06/hmrc-tax-deal-vodafone
According to the Centre for Policy Studies, in a global environment where job creation is crucial for economies to recover from recession and increase the tax take in the context of fiscal deficits, there is emerging pressure for governments to incentivise companies to operate in their territory by reducing corporation tax rates. This is in danger of becoming a ‘race to the bottom’ and further diminishing a company’s direct financial contribution to government. Any such dynamic will heighten the need for business to rediscover a more integrated social role, as it might otherwise have outsourced its social responsibilities to government, have a very low taxation burden and effectively end up with its only social role being the provision of employment – which it seeks to source from the lowest cost geography.

Charity

Charity goals are diverse. As Lucy Bernhol tz said, “philanthropy is – by design – episodic, donor directed, temporal, fragmented, decentralised and disaggregated.” The End of Charity, published in March 2011 explains the limitations that ensure that – for all the undoubted good that charitable and philanthropic intervention do in the world – they are unable to address the causes of problems. Instead, they can become efficient at responding to certain symptoms of these problems. Because their expertise has been in delivery of social service, rather than in creating financial value, the charity sector generally has a low level of financial literacy and a high level of social literacy – the inverse of the financial or business world.

In response to their lack of reliable access to capital, much charitable intervention in society has been, to a significant extent, nationalised over the last 30 years. Whether by tendering for government contracts in Welfare societies, or by pitching for aid contracts in emerging economies, most charities of significant scale have come to rely on some form of government funding to operate. This effective nationalisation has resulted in charities suffering from the same phenomena as direct government provision as the state retreats in light of financial unsustainability.

However, because of their history and the unique motivation of their founders and managers (who continue to labour for positive social outcomes despite the disabling environment that surrounds them), charities are often uniquely placed to deliver the social outcomes sought by government and social investors, and hence are likely to have a key and enhanced role to play in any re-alignment of capital operators within society.

Issues of Government Legitimacy

The separation between those concerned with achieving ‘social’ outcomes, and those achieving financial outcomes risks leading to a society where one half of society is financially literate but socially illiterate, and vice versa. This is reminiscent of C.P. Snow’s ‘Two Cultures’ essay from 1959, which described the increasing estrangement between the sciences and the humanities in society.

Increasingly over the last fifty years, the class system has been eroded away. This is not least thanks to the success of the Welfare State, which at least for a time succeeded in reducing the absolute poverty rate in the UK (from 16.8% in 1960 to 8.7% in 1991). Class extremes have been substantially replaced by a pluralistic middle class.

Sources:

29 http://www.cps.org.uk/publications/reports/how-to-cut-corporation-tax/

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POLITICAL CONTEXT

Business, government and charity, and their inter-relationships, all operate within a political context. It is worth highlighting a couple of salient points of context (whilst recognising the risk of applying such a snapshot approach).
Because law-making in a welfare society is primarily about law and public service, well over half of elected politicians come from either the legal profession or the public services. This is despite there being four times as many private sector workers to public sector workers in the UK. Politicians are, in this respect, not representative of the general population. The monopoly nature of the public services is likely to compound this as it is likely to be insiders and technocrats who are best placed to understand how to navigate these huge institutions and effect change.

With laws becoming ever more voluminous and complex, it is natural for parliament to evolve into a more technical, rather than a strategic or principle-based, body. It could even be argued (and often is in private) that our politicians have become relatively powerless to effect change in the context of election cycles and in the face of complex machines and entrenched interests on both sides – the financial markets and the interests of business on the one hand, and government monopolies and bureaucracies on the other.

All this is likely to have had the effect of distancing the ‘ordinary’ citizen from government – and might enhance the feeling that the social contract is not optimally serving his or her interests.

As government is perceived as failing to honour the social contract, and as citizens feel cut off from both it and from the opportunity to influence it, behaviour amongst citizens might start to change. As well as not turning out in elections, and expressing lower confidence in government, some citizens decide to opt out of their obligations under the social contract. They stop obeying laws and paying taxes.

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Another indicator of the eroding legitimacy of government is the proportion of citizens who are willing to break the social contract by breaking the law. It is estimated that 2.8 million citizens engaged in business with criminal gangs by purchasing illegal drugs in 2009/10\(^4\). This is more than one in twelve of the UK population.

**Issues of Business Legitimacy**

With its focus on returning profits to shareholders, business risks being perceived by people as exploitative – interested purely in how it can extract financial value from them, as either employees or as consumers. One response to this is to respond in kind. For example, it has become routine and socially acceptable to steal from big business – an estimated 7.7 million individuals regularly break the law by illegally downloading music\(^4\).

Another is more mercenary behaviour by employees – the US Department of Labor estimates that those currently in education will have had 10-14 jobs by the age of 38\(^4\). Symptoms of reduced legitimacy for business and ownership abound, from the rioting of August 2011 in the UK – where a sizeable minority decided to consume without honouring the contractual terms of consumption – to the sentiment of January and February 2012 which led to a series of business leaders choosing to bow to a public mood which was demanding that they forgo some of their remuneration entitlements. As Stephen Hester put it, he did not wish to become ‘a pariah’.

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40 The Guardian, 27th January 2011
41 Harris Interactive quoted by the British Recorded Music Industry, December 2010
42 US Department for Labor quoted in Did You Know, McLeod et al
The truth is that right now, we do not know. The holistic stewardship of capital was practiced for millennia. But it is not practiced in our modern capitalist/welfare democracies. Whether it is possible to take an holistic approach in the modern world is the subject of explorations and experiments. These are not resolved either way.

The purpose of this booklet is not to come up with ‘the answer’ to this question. But by understanding the past and present, it hopes to illuminate some principles and ideas that may remove barriers to a more holistic operation of capital in our societies and put an end to the bipolar capitalism of the present.

These principles and ideas are at once a statement of the bledin’ obvious and an impossible aspiration. That they should be both at once surely illustrates the need for change, and the inevitability that it will come whether we like it or not.

"I am not brutally selfish, blindly unjust, or fiendishly ungrateful … it would please and benefit me to have five thousand pounds; it would torment and oppress me to have twenty thousand; which moreover, could never be mine in justice, though it might in law … I need not narrate in detail the further struggles I had, and arguments I used, to get matters regarding the legacy settled as I wished. My task was a very hard one: but as I was absolutely resolved - my mind was really and immutably fixed on making a just division of the property”.

- Jane Eyre

Our Capital is our firepower.

It acts like soldiers that we send out into the world to follow our orders. If we order those soldiers to find anything that they can of value, remove it and return it to us, then we become like a plague of locusts.

Yet we could instead order those soldiers to go out into the world and ask them to build capacity wherever they can whilst also paying for themselves in whatever way they agree with the communities that they are residing in.

The big emerging question is whether it is possible for our firepower to be used in a way that reflects all of our objectives, rather than simply our financial objectives. We all know that money can talk. But can it sing?

43 A fine description of the logical extension of how this works was written by James Surowiecki in The New Yorker, http://www.newyorker.com/talk/financial/2012/01/30/120130ta_talk_surowiecki. German SPD Party Secretary Franz Müntefering was quoted in Bild as saying "some financial investors spare no thought for the people whose jobs they destroy. They remain anonymous, have no face, fall like a plague of locusts over our companies, devour everything, fly off to the next one".
Dis-aligned capital creates social and economic costs. It also results in a capital deficit where patient, and potentially higher-risk, investment for social return is needed. The volumes of capital that are currently deployed by government are sufficient to enable it to change the orientation of the market, should it choose to do so. Government has the buying power to change the nature of much of the capital in our society. It can do this by incentivising it to deploy into social businesses (Theory #1). These social businesses require a blended capital structure (Theory #2). A process is required to enable assets owned by state monopolies to be transferred to such social businesses, in such a way that enables them to respond to the customer demand of government procurement (Theory #3).

**Theory #1: Government Embraces Markets and Buying Power**

When all is stripped away, government has two levers: taxes to raise finance from citizens so it is able to honour its responsibilities, and commissioning to procure outcomes on behalf of citizens. If the government ceases to see itself as a provider of services, instead seeing itself as a user of capital to procure outcomes, the potential for a fundamental rethink becomes possible. The commitment to greater provider plurality in health and education, as well as the introduction of personal budgets so that people can commission their own services, are steps in this direction. It is possible to rethink government in this way regardless of current political persuasion or preconceptions about whether government intervention is something desirable or otherwise. Those debates will continue. But changing perspective to see government’s role differently opens the door to a more fundamental appraisal of how government can best align interests in society and achieve the goals of its citizens.

The primary role of the government would be as the major customer to service delivery enterprises. Government procurement would no longer be seen as purchasing physical things, specific service level agreements or IT services, but would instead become a core purpose of government.

So long as delivery entities are private interests owned by shareholders who have a narrow financial objective on the one hand, or public sector monopolies on the other, dis-alignments will persist.

But with its buying power, the government could refuse to do business with any such enterprise, instead restricting its trade to social businesses, owned by those with both financial and social goals.

In such a situation, financial markets would quickly adapt to serve the needs of this new market opportunity – which represents over 1/3rd of the UK economy. The existing capital landscapes would then simply accept social businesses as part of the landscape, with social businesses mirroring the enterprise and financial characteristics of conventional businesses.

**How The Social Capital Market Will (and is already starting to) Work**
Definition and identification of a ‘social business’ would be achieved through ownership qualification as a social business would depend on certain social, charitable or community shareholders benefiting from certain shareholder rights. One such shareholder might be the government itself. The social purpose would be assured by having shareholders with appropriate rights who are primarily motivated and incentivised by the social value created by the business. If this is to be properly achieved, more than one kind of capital needs to align within one structure.

If government really does embrace markets, and the true power it has as a buyer of social outcomes, then the role of government will fundamentally change. One key area for change would be in government procurement. Buying outcomes, rather than outputs requires an investment approach rather than a commissioning approach. These are two different things. Such a change is likely to run counter to the culture and the methodology of the current commissioner universe. Failure to engage with this point is likely to lead to implementation failure. Other implementation issues associated with government fully embracing markets and buying power are not explored here.

**Theory #2: Blended Capital Structures**

*Social outcomes are about human change.* Whether an individual makes a contribution, or represents a cost to the state is the result of a large number of factors. These different individual elements – such as family background, education, skills and so on – are all embedded together in an individual:

The state intervenes to improve social conditions because society has come to see these interventions as the rights of that individual. It does this by providing services such as healthcare, education, skills and training, employment – and then by providing acute services and a safety net if things go wrong for that individual.

"Capitalism is seen as arrogant, but that is merely the rage of Caliban on seeing his reflection. The extraordinary thing about Capitalism is its humility and refusal to judge. It will give us what we want; it will not force on us what it thinks we need. Often we are disgusted by what we discover we want – but that reflects on us, not on the servant who brings us our fetish gear and saturated fats. It would bring us organic turnips just as happily."

- Julian Gough, Prospect Magazine, 2008
The state has evolved to do this through spending departments:

Necessarily, budgets must be set for these spending departments. The process of doing so is not directly related to the aggregated needs (or ‘demand’) of citizens, but is instead set by arbitrary factors, most notably custom and practice (or ‘history’) and politics.


1. Environment protection and community amenities - £26bn
2. Housing - £26bn
3. Public order and safety - £34bn
4. Economic affairs - £40bn
5. Education - £91bn
6. Health - £121bn
7. Economic affairs - £40bn
8. Social Protection - £232bn
9. Economic affairs - £40bn
10. Economic affairs - £40bn

Drawing to scale in relation to spending per department
By definition, this evolved system of spending departments, which are operating to meet their narrow departmental brief, are not established to interface with the complex needs of the citizen as an individual. They are not able to consider the complex and often inter-related needs that a troubled individual might have if they are to be transformed from being a net cost to society to being a net contributor to society. For example, if a repeat offender is to transition from a life of petty crime to a sustainable life of contribution, he or she might need to address addiction issues (Department for Health); literacy issues (Department for Education); worklessness (Department for Work and Pensions); Homelessness (Local Authority); mental health problems (Department for Health); family mediation (charities), as well as needing a positive relationship with the police and probation service. But rather than align around that individual to help him to turn his life around, the capital instead seeks the provision of a prescriptive statutory service that operates in isolation of others.

Government operating its own capital in these departmental silos mirrors the way in which capital more generally in society is operated:

*The Present: Capital in a Silo*
If certain social outcomes for citizens are to be achieved, then capital must break out of its silos. For government, this means seeking a human or community outcome, rather than seeking only the provision of a particular prescribed service. And for society more generally, this means seeking a reasonable financial return in the context of a positive social contribution.

For this to be possible, new equity structures are required. The dangers of private interests dis-aligned from government interests working too closely together was highlighted in February 2012 with the furore surrounding A4e. All of this could be avoided by an equity structure which has a fiduciary interest in the social outcomes of that enterprise whilst also accommodating the reasonable financial needs of capital providers. The right capital structure might create a new ownership dynamic.

Such a structure could enable government to define the unique role that its capital can play, so that it might fulfil the appropriate role within a capital structure.

So capital might evolve:

*The Future: Integrated with clearer roles*

Moving to an integrated capital structure for social outcomes will enable government to leverage in other funds, (such as the £3.9 trillion of investment capital shown on p-14) to pay for social interventions:

*The Future: Clearer roles lead to greater efficiency*
Such a structure has been described by Stephen Lloyd of Bates Wells Braithwaite in what he calls a 'Social Enterprise LLP' (SELLP). Lloyd described the features of the proposed SELLP in The Barrister Magazine:

- It would be established to achieve a charitable purpose as defined in Section 2 of the Charities Act 2006. The SELLP would not be a charity but it could only be a SELLP if it is established to achieve exclusively charitable purposes.
- Just like any other LLP, it would be obliged to be transparent in terms of filing information with the Registrar of Companies in terms of its Members and its Accounts.
- Just as the Community Interest Company is regulated by the CIC Regulator to ensure that it complies with the CIC legislation, it is proposed that the SELLP should also be regulated by the CIC Regulator to ensure it abides by its social enterprise obligations.
- Just like a CIC on formation, an SELLP would have to declare what charitable purpose it will achieve.
- Just like a CIC, an SELLP would have to file an Annual Return to the CIC Regulator specifying how it has achieved its charitable purposes and social impact.
- It is proposed that there must be at least one Charity Member of the SELLP and a minimum of 30% of the LLP’s equity must be owned by a charity or charities. The Charity Member could not be connected in any way with any of the other investors in the LLP.
- The Charity Member would have a golden share which would mean that there could be no change to the purposes of the SELLP or change to its Partnership Agreement without its consent.
- At least one member of the Management Committee must be appointed by the Charity.

With the appropriate investor rights for the charitable purpose, it would not be necessary for the Charity Member to own as much as 30% of the SELLP’s equity, as suggested, which could unnecessarily constrain its application.

The key is that there is no prescribed, inflexible cap on the cost of capital. This is something to be agreed by all the partners in the context of the social mission of the partnership.

A blended capital structure such as this opens the way for a new alternative to Nationalisation or Privatisation – Democartisation.

**Theory #3: ‘Democratisation’**

(as an alternative to Nationalisation or Privatisation)

Over the last two years, considerable work has been done on ‘mutualisation’, ‘employee ownership’ and ‘localism’. This important work seeks to align capital, but struggles because it seeks to do so in the context of an inflexible and asset-locked structure with complex governance. This restricts the ability of private capital to become involved and so restricts the opportunity for such interventions.

The Technicolor world of blended capital structures, on the other hand, provides the potential for the state, as asset owner, to democratising ownership of public services in a flexible way. Blended capital structures enable social investors on the one side (e.g. communities, local people, interest groups and charitable foundations) and private financial investors on the other to invest alongside the state for social outcomes. By retaining a ‘carried interest’, the state remains a stakeholder and can build in whatever protections (‘investor rights’) that it requires to protect the social mission, in the context of giving investors what they need if they are to invest.

This ‘Democratisation’ is, therefore, quite unlike ‘privatisation’ on the one hand and mutualisation on the other. Privatisation replaces government capital with private capital. Mutualisation changes the ownership of the capital. Democratisation enables assets to be held within blended structures where financially motivated and socially motivated investors agree on how to maximise the creation of the value that they respectively seek. This will result in better stewardship of any physical assets, as well as a more balanced operation of any services delivered to government by the democratised social business.

As an alternative, democratisation enables the evolution of government-run monopolies (e.g. care homes, certain schools and universities, certain health providers and so on) into social businesses owned and operated by aligned stakeholder-investors. The state is likely to remain involved as a shareholder, but may also include charitable foundations, local people and businesses, and financial institutions such as pension funds and banks. Investors might be anyone who can align to the stated and enshrined social and financial goals of the social business being listed.

Such a process would enable flexibility on an enterprise-by-enterprise basis. The unique needs and circumstances of the enterprise to be Democratised would be accommodated in the negotiation between the state, social investors and financial investors, as the interests of them all are aligned in the structure. Should agreement not be reached then the state, of course, has the potential to pull out. Ultimately the existing asset owner (the state) will be able to control the investment process, including the nature and rights of new investors. There may be a number of protections and safeguards that the state might put in place to achieve this, for example:
• Retaining a significant interest / shareholding
• Establishing trusts to hold a different class of share (or a ‘golden share’)
• Creating asset-locked structures (e.g. CICs) into which these assets are structured
• Using an SELLP structure (see Theory #2)
• Listing on a Social Stock Exchange, a core purpose of which is to protect social mission
• Excluding certain kinds of private interest from share purchase

By converting government-owned monopolies into stake-holder owned, state-enabled social businesses, citizens and other natural stakeholders might be offered ownership and involvement in their operation and success.

One example of this might be universities. They currently have charitable legal status. In a world where emerging economies are becoming richer than the old industrialised western economies, the most populous nations on earth are driving unprecedented demand for education. It is natural that their favoured educational solution is old-world universities with heritage, track record and hundreds of years of expertise and accumulated knowledge. There is therefore a significant opportunity for UK universities to expand overseas and to return value to their current owners, the British people. In order to do this, they will require two key things:

1. Access to management capable of maximising the value of the opportunity for the owners
2. Access to capital to fund the management’s plan

Governments are not placed to do either of these two things. However, involvement of outside capital not only removes the financial barriers to expansion, but can also involve those with the skills and knowledge required to deliver an expansion strategy – for example, social venture capital operators and university alumni.

Other social business forms, such as Community Interest Companies and B-Corporations could complete the toolkit for those who seek to align the social and financial requirements of capital and combine them in a unified structure.

Much of the public sector labours in bondage. Because the allocation of resources is arbitrary, rather than determined by the market, public sector entrepreneurs and leaders do not have reasonable or efficient access to capital to implement their good ideas. Capital is instead deployed through a monopolistic allocation system. The inefficiency of such a system leaves much of the public service labouring under an impossible workload, whilst other parts are given the impossible task of analysing need and allocating resource in a vacuum – without a market environment to inform the allocations.

If alignment is to be achieved, certain fundamental principles will need to be embraced. These might form the basis for debate about how they may be applied. Here, for a start, are ten principles. Agreement that the market is an efficient means of allocating resources is an essential pre-condition. Therefore, government’s role becomes about incentivising the right behaviour and intervening in a market-sensitive way when necessary – through price manipulation using tax incentives for socially value-creative behaviour, and tax penalties for socially value-destructive behaviour.
PRINCIPLE 1: BUSINESS ACCEPTS RESPONSIBILITY
In exchange for an enabling environment, business has a responsibility to support and preserve that environment – socially and environmentally. Not only therefore is destructive behaviour penalised in such a way as to provide a genuine dis-incentive, behaviour that creates shared value is incentivised. Business can therefore take advantage of the incentives of Principle 7, and be dis-incentivised by the sanctions of Principle 6. A key driver in this is for the concept of fiduciary duty to rediscover its advantage of the incentives of Principle 7, and be dis-incentivised by the sanctions of Principle 6. Early intervention and prevention is proven to be significantly cheaper than paying to deal with the consequences of social problems. It is rational for investors to focus on prevention, but is often not for government budget holders. This is especially true where savings are not reaped by those who pay for the prevention, or where immediate critical needs consume all available capital.

PRINCIPLE 2: GOVERNMENT LIMITS SOCIAL LIABILITIES
Citizens take on greater liability to supply their own welfare service needs. Where this line is drawn will be the subject of political debate, but the need for some constraint is clear – expectations may not be limited, but budgets are. Pricing might be used to encourage responsibility, such as higher tax rates for those indulging in risky behaviour, user charges, or voucher systems.

PRINCIPLE 3: FOCUS ON PREVENTION
Early intervention and prevention is proven to be significantly cheaper than paying to deal with the consequences of social problems. It is rational for investors to focus on prevention, but is often not for government budget holders. This is especially true where savings are not reaped by those who pay for the prevention, or where immediate critical needs consume all available capital.

PRINCIPLE 4: COMPETITION FOR STATE MONopolIES
If alignment of interests is to be achieved, competition can only be introduced through ‘democratisation’. The democratisation process will involve the break-up of state monopolies into intelligible and coherent social businesses, and the introduction of new providers. These can then compete for state business (or the custom of service users), and may be given a competitive advantage if the state opts to source exclusively – at least for a period – from democratised social businesses.

PRINCIPLE 5: FUNDAMENTAL CHANGE TO REGULATION
In order to make it easier for more private capital to be deployed for social outcomes, particularly in smaller enterprises or funds, regulation might be re-oriented to empower the investor rather than constrain the issuer. The extent to which investors may participate in investment opportunities will be driven more by the sophistication (experience and track record) of the investor. Such a system would be designed to empower citizens by constantly increasing their knowledge to make informed decisions that affect their own wealth.

PRINCIPLE 6: PRICE NEGATIVE EXTERNALITIES
Government can explore the potential of a system where negative social costs of business are measured and directly charged to business, so appearing as a cost line on their profit and loss accounts, and a corresponding income line on that of government. The complexities of doing this are considerable, and are likely to focus on measurable negative externalities (such as carbon emissions, pollution and foods with certain nutritional characteristics). Many negative externalities are less easily measured, such as behaviour change as a result of consuming sexual or violent media content. However, no serious efforts have yet been made to price negative externalities beyond certain ‘sin taxes’ on alcohol and tobacco, and the opportunities for doing so are worthy of deeper exploration.

PRINCIPLE 7: PRICE POSITIVE OUTCOMES
A tariff for achieving positive social outcomes is needed to underpin fundamental changes to commissioning. Government commissioners might contract with any approved provider to deliver those outcomes, who would be remunerated for doing so on a success-only basis. The pricing needs to give the opportunity to earn a competitive risk adjusted financial return for investors. The justification for providing a budget for such outcomes payments needs to be based on an efficiency or superiority – and not necessarily payback – argument to government. The temptation to focus on short term, easily measurable outcomes (such as ‘bums on seats’ on vocational training courses amongst youth previously not in education, employment or training) might be hard to resist.

However, for true change to be achieved, focus needs to be given to long term, holistic outcomes. The different social cost borne by the community between one individual living a life of work and contribution versus that same individual living a life of crime and worklessness is profound. Attendance on a vocational training course for a few weeks may not be a sufficiently correlated outcome to justify an outcomes-based approach. It is only by focusing on the long term value created to society by achieving certain long term outcomes with individuals that the effort and complexity of understanding how to price the outcomes, finance the interventions, manage the interventions and measure the results will be justified.

PRINCIPLE 8: TACKLE THE SHADOW ECONOMY
The corrosive effect of the Shadow economy should diminish in an aligned system. As alignment produces benefits, so penalties for breaking the social contract need to become harsher (e.g. for tax evasion). Other dis-alignments must be tackled. For example, significant power is given to criminal gangs by the prohibition of certain behaviours or products that a significant proportion of the population wish to purchase. By removing certain prohibitions, society could benefit by removing this power from criminal gangs and effectively nationalising it.

44 Professor Michael Porter http://hbr.org/2011/01/the-big-idea-creating-shared-value
PRINCIPLE 9: COMPETE IN A GLOBAL CONTEXT
If a system is introduced that causes capital to flee to friendlier climes, this is likely to prove value destructive to society. All changes need to be considered in recognition of the globalised and liquid capital marketplace context.

PRINCIPLE 10: INVOLVE THE PEOPLE
In recognition of both the information revolution, and the experience of a dis-aligned system causing disenfranchisement of citizens from both government and business, to involve them in the new aligned system in every way possible within the context of good governance. For example, one way that the people might become involved is by using social networks to operate their buying power in a co-ordinated way to reward businesses which take a positive role as a member of society, and boycott businesses which retain a narrow focus on financial extraction.

Which?, the UK consumer campaigner, has recently started to organise consumers in this way, most notably with energy buying.

CONCLUSION

The need for change is clear. The debate over the ‘future of capitalism’ has, latterly, begun. Businesses, governments, charities – all operators of capital in our society agree that the status quo is not working and is not sustainable.

In many respects, this booklet will raise more questions than it answers. The devil is in the detail.

Yet guiding principles are required. And guiding principles are difficult because they must be worked through. What counts is that interests are aligned within society. All of the different participants within it – who each have unique skills, expertise and tools to contribute – need to be aligned and able to pull together.

If head teachers and senior bankers, surgeons and supermarket bosses, union leaders and management consultants were all on the same team, pulling together, the potential for value creation for us all is immense.

Such potential is sufficiently great to warrant the hard work to think through how we might re-shape the systems and institutions of our society to create such an alignment.
Panahpur is a faith-motivated family trust established in 1907. For 100 years we were a traditional grant-maker. In 2006 we sold some properties and experienced a ‘capital event’. We were told to invest the capital into financial markets for exclusively financial return, and then to give away the income. Yet the data suggested that modern capitalism was causing increasing inequalities in society, and experience suggested that inequality and poverty were a major cause of the distress that necessitated our charitable activity. The trustees questioned whether there might be a less contradictory way for our foundation to operate and started to experiment with ‘social investment’, or ‘impact investing’.

Since then, Panahpur has invested in the Social Stock Exchange, the Big Society Finance Fund, the first Social Impact Bond in HMP Peterborough and numerous other funds and enterprises seeking to integrate financial and social objectives.

“As in a matter of this sort it is useless to make a trust unless the trustees can be trusted. The fullest powers are accorded to them so that they can do anything the owner of the capital could do himself.”

– Colonel Sydney Long Jacob, Panahpur Founder, 1911

ABOUT THE AUTHOR

James, with his brother, has spent the last 12 years building their social hearted business, COOK (www.cookfood.net). It now employs around 450 people and is rolling out nationally. Since 2004 he has been working with Panahpur – initially experiencing the potential, and the constraints of charity - and latterly seeking solutions to those constraints. James has written extensively on charity and ‘social capitalism’ and divides his time between his work with Panahpur and his directorship of COOK.

He is married to Jennifer and they have three children.

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“All of our gods have failed us” – Dr Chris Wright

By the end of the 1980s, Capitalism had ‘won’ the debate about how resources would be allocated. The Iron Curtain was torn apart. The market overcame autocracy. It was ‘The End of History’.

Yet little more than 20 years later, the different operators of capital in our society – government, business, charity and individuals – have become increasingly at odds with one another as they seek different outcomes. Markets operate capital that recent experience shows to have had a parasitic effect on society.

Can capital be rehabilitated as something with a positive social role?

Can the undoubted power of markets be put to work for the good of society as a whole?

Is there an alternative foundation upon which modern societies may be built – a foundation which embraces the value of both markets and government, which accommodates the needs of investors and society?

These are becoming the questions of our time.