

Global Capitalism and the Rise of Private Equity and Outsourcing

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Abstract

The popularity of contracting out or outsourcing has remained undiminished in both public and private sectors as organisations seek to satisfy their many stakeholders that they function in an efficient and cost effective manner. The rise of contracting out can be attributed to the ideological support for contracting out provoked by the free market economic policies popularised in the 1980s, universal pressure on costs, and the encouragement of authors as diverse as Peters and Waterman (1982) and Friedman (2005). An emerging funding source for both public and private sectors is private equity capital. Once associated with high risk ventures but now financing mainstream corporate activities, the rise of private equity has been sudden. This paper draws together the combined themes of contracting out and private equity with particular emphasis on the lack of financial performance and transparency created by each, and their potential impact on competitive markets and global capitalism?

Introduction

The post-World War II era marked the beginning of a time governed by Keynesian economic principles with their promise of full employment policies and an expectation of significant and effective government involvement in economic management (Galbraith, 1987; Cavanagh, Wysham & Arruda, 1994). The ensuing quarter century several economic upturns and comparatively minor recessions (Galbraith, 1992; Chevallier, 2000) as well as expanded US expenditure on domestic social policy in the USA and elsewhere (Jacob, 1966; Galbraith, 1977). The honeymoon with Keynesian economics started to abate, however, in the 1970s. The wars taking place in Vietnam and the Middle East affected global economic performance and oil prices, driving price inflation in many jurisdictions (Grenville, 1997; Stevens 2001). The Keynesian prescriptions were also questioned by neo-classical economists (Friedman, 1982; Buchholz, 1999; Canterbury, 2001) who criticized the impact of government fiscal policy on the free operation of markets. The promotion of free-market policies, although appearing to resurrect many of the features of nineteenth century philosophers, such as John Stuart Mill (Dunning, 1920), offered an acceptable alternative to the Keynesian approach. It was time for a new economic miracle (Galbraith, 1977).

By many accounts, the miracle has occurred. The emerging economic strength of China, India and many other Asian economies, noted enthusiastically by Friedman (2005), and general economic evidence reflects a comparative stability in world economic forces (Browning, 2007). While China remains seemingly adamant about preserving its current economic and political order, other trading blocs can hopefully be expected to come to terms with the new order and its opportunities and constraints. Stock market performance continues to rise (Browning, 2007), global exchange rate stability is not significantly challenged, the European Union is expanding its economic frontiers, the former Communist states of Europe continue their economic reform, and inflation rates have not significantly impacted on the global economy. There is also continuing concern that China's economic boom may end and as a consequence cause economic difficulties around the world (Economist, 2007).

Table 1: Pattern of Changing Government Expenditures (as a % of GDP) 1980-2004

<i>Country</i>	<i>1980</i>	<i>1985</i>	<i>1990</i>	<i>1995</i>	<i>2000</i>	<i>2004</i>
<i>Australia</i>	34.0	34.7	33.0	35.6	35.3	36.1
<i>Canada</i>	40.5	45.1	44.2	44.4	38.5	36.2
<i>France</i>	46.1	50.9	45.7	58.2	62.5	55.1
<i>Italy</i>	49.9 ²	49.9	46.1	49.4	44.4	46.0
<i>New Zealand</i>	47.0	41.5	48.7	31.7	35.5	34.7
<i>United Kingdom</i>	44.9	43.8	41.5	42.9	38.7	38.7
<i>USA</i>	33.7	34.0	33.5	33.0	30.2	30.8

Source: Original table. Data adapted from Gwartney, Lawson and Samida (2002), and Gwartney, Lawson and Easterly (2006).

Note: ¹ Alphabetical order of entries follows the protocol of the Report; ² Estimate.

Behind these shifts, however, are further intended and unintended outcomes. The shift towards 'smaller government' has tended to give a greater share of economic activity to the private sector, as demonstrated by the data in Table 1. Smaller governments have also translated into lower tax rates in many jurisdictions and pressure on governments to continue to provide yet further tax reductions. Government agencies generally find they have to become more cost effective, with 'doing more with less' being a typical catchphrase. One of the ways of reducing costs has been to outsource activities once carried out by government. Transport, energy generation and transmission, infrastructure projects and even water supplies have been outsourced by government agencies to reduce the capital outlays likely to affect government debt loads and their associated credit ratings. This action is supported by an ideological belief that the private sector will make a profit on the task because it is expected to provide the service or product more cheaply than government. Many of these ventures involve private equity capital.

Contracting Out or Outsourcing

Contracting out is a well established business practice. It involves the transfer to a third party of the responsibilities for conducting activities originally undertaken by a principal. In these cases, particular activities are completed by an external organisation

under the terms of a contract between the principal and the contracting firm. The activities are as simple as debt collection and as complex as operating an organisation's IT system, the construction and management of a penal facility or the construction and maintenance of public infrastructure under a 30 year contract, and is often referred to as a Public-Private Partnership or PPP. The term 'outsourcing' is generally assumed to be interchangeable with the term 'contracting out'. Farazmand, (2001) has described contracting out as a form of privatisation. This may appear to be an extreme view to some jurisdictions where the contracting process is seen as a normal transaction for both public and private sector organisations, but the financial impact is nevertheless seen as a shift in the public-private mix.

The economic trends of the past half century have given great impetus to this element of business behaviour, especially in relation to government. The history of contracting out can be traced to Darius the Great during 'the Persian world-state Achaemenid Empire (559-330 BC), in which two financial banking houses ... were contracted out by the State for collecting fixed property taxes' (Farazmand, 2001: 3). As will be discussed, the popularity of contracting out has coincided with the emergence of privately held capital, itself a form of public good even though held in private hands. Of course, colonial rule encouraged some form of contracting out to be undertaken under the control of the ruling country. However, the economic trends of the past half century provide a demonstration to the changing ideologies that have resulted in outsourcing and in private equity being key features of the current financial landscape, irrespective of the lessons learned from colonialism

The contracting out process is not limited to government. Most organisations regularly face 'make or buy' decisions that involve supply chain partners; that is, external trading organisations which contract to provide the required goods and services not readily provided 'in-house'. The contracting process provides a well established solution (Farazmand, 2001) and is supported by populist promotion of contracting out in literature covering both public and private sector perspectives on the issue (Peters & Waterman, 1982; Osborne & Gaebler, 1992; Farazmand, 2001; Friedman, 2005). However, the contemporary ideological shift to contracting out may reinforce the 'buy' choice and replace a reasoned decision about the 'make or buy' choice. There is evidence that contracting out decisions may be made without a full cost-benefit assessment. For example, over ten years ago Domberger and Hall (1995) and Hodge (1996) produced research suggesting that the cost benefit consequences of contracting out were ambiguous. In addition, organisations may be likely to find the full cost of outsourced product or service provision - the cost of contract management plus the cost of the outsourced goods or services - exceeds the cost of doing the job in-house.

This weakness was discussed by Williamson (1985), who noted that the transaction cost of contracting out could significantly affect the benefit assumed to be created. The veracity of this claim can only be established if the costs of an activity are fully understood at the outset of the outsourcing decision. Anecdotal evidence suggests few organisations are able to undertake a complete financial analysis of the comparative costs of in-sourcing and outsourcing (because they do not possess an Activity Based Costing capability).

Furthermore, there is a loss of control over the outsourced activity that may weaken the traditional role of management.

In theory, a well crafted contract supported by a complete specification should enable a contractual situation to be managed as readily as a process being managed in-house. In theory, a contract completed *on schedule, on budget and according to the specification* creates a satisfactory financial outcome and a precise summary of all costs (assuming quality and reliability goals are achieved). In practice, the situation may be more complex, especially when contracting out is linked to global sourcing activities. Organisations are increasingly contracting out and off-shoring their activities in the apparent belief that the cost advantages outweigh the inherent delivery and produce quality risk (Friedman, 2005).

Outsourcing or contracting out also permits organisations to contract the provision of goods and services at a higher level of sophistication than they possess in-house. This is an advantage and disadvantage as contracting out may up-skill an organisation's capability, but how does it obtain the skills required to evaluate and manage the contract in the absence of in-house capability? Contracting out decisions appear to be made with a mixture of advice from external advisers, and/or the use of past experience, and/or 'gut reaction' and/or just taking a risk. In these circumstances the organisation is delegating its performance to one or more contracting out providers without having in-house capability. One way of managing the process is to rely on an external advisor to monitor the contract process and advise on its technical characteristics. Another is to employ 'specialists and people of unusual talent' (Henry, 2001: 98) to provide specialist in-house advice. Once again, the transaction costs may be significant. It is difficult to find a balance between the cost reduction benefits of contracting out and the capability requirements of the organisation seeking to contract out goods acquisition or services.

The final outsourcing issue to be explored here is that of transparency. A principal who chooses to 'make' a product has an intimate knowledge of the cost, technology, componentry and labour skills required to complete the product. There may also be research and development undertaken by the principal to complete the task; all of it within the knowledge and control of the principal. Outsourcing shifts the production of the product, or the provision of the service, to the contracting agent. In the process, the tasks, its discrete costs and the knowledge to complete the activity potentially shift the capability from the principal. The entire process becomes opaque, outside the knowledge and management control of the principal. It is the loss of transparency and capability that links the typical contracting out to the rapid emergence of private equity capital.

Private Equity Capital

The notion of private equity capital has undergone a renaissance over the past five years. It has been defined as a 'broad term that commonly refers to any type of equity investment in an asset in which the equity is not freely tradable on a public stock market' (Wikipedia¹, 2007). By contrast, Bannock, Baxter and Davis (1998) define private equity capital largely in terms of risk; the use of investment funding for new or high-risk activities. Now a focus of major investment groups, private equity capital is engaging in

wide-ranging buy-outs of previously listed corporations. While private equity capital has long existed, some aspects of its origins are worth recounting.

The history of private equity capital could be examined in many ways. Firstly, it is inexorably tied to the history of capitalism. Some very brief insights into the history of capital may be relevant, though without reaching quite as far back as Darius the Great (Farazmand, 2001). As the source of Anglo-American capitalism can be found in the United Kingdom (UK), this has been selected as a starting point. In the early 1700s, and prior to the conceptualisation of Smith's *Wealth of Nations* (1776), the British Parliament had experienced a fundamental shift in power. The membership and control of the House of Commons (the lower house of the UK Parliament) shifted to a much broader social franchise that significantly reduced the power of the land-owning wealthy (Gibbins, 1897, 1901; Southgate, 1934; Roll, 1973; Landreth & Colander, 2002). The scope of this change led Gibbins (1897: 472) to remark that by the late nineteenth century:

... the position of the working-classes has been vastly improved in their political relations, and there are many signs that they are using their political means - as other classes have done - to gain economic ends.

The changing structure of British Parliament at this time was also associated with a decline in parliamentary support for commerce, which had previously been a feature of British colonial imperialism for some centuries (Gibbins, 1897; Dunning, 1920; Southgate, 1934). The emerging commercial ethos was labelled as *Mercantilism*. This period of UK history (Gibbins, 1901; Southgate, 1934) roughly matched the period 1500-1750 (Landreth & Colander, 2002) and centred on (Gibbins, 1897: 362): 'the accumulation of treasure [bullion] ... the development of shipping as a nursery for the navy; and ... maintenance of an effective population both for commercial and military purposes'.

According to Landreth and Colander (2002: 44), Mercantilism could be regarded as the 'intellectual reaction ... to the decline of the manor and the rise of the nation-state'. Roll (1973: 63) argued that while the precise period that may be described as Mercantilist is subject to argument, the common attribute was that:

... most pieces of mercantilist policy ... identified the merchants profit within the national good ... state power was at once turned to a new use ... it was true for a time state regulation was an essential condition for the widening of markets beyond their medieval limits ... It is generally conceded that mercantile capitalism preceded and prepared the ground for modern industrial capitalism ... The mercantilists demanded a state strong enough to protect the trading interest and to break down the many barriers to commercial expansion.

However, this general policy had also led to unexpected power being given to corporate bodies such as the East India Company, which later British governments struggled to control over the period 1784 to 1833 (Roberts, 1980; Webster, 1990). Will history repeat itself in relation to private equity, where governments may find it necessary to regulate?

The value of the Mercantile approach was that commercial goals were conceptualised at a national rather than individual level. While in practice it seems that individual business

people made significant personal gain, national development was a central politico-economic concept. Economic development was based on a national commercial perspective supported by a parliament in which 'Individual traders ... were discouraged, and from the sixteenth to the eighteenth centuries commerce was carried on by great companies which ... enjoyed a monopoly of trade between England and some definitely specified part of the world' (Southgate, 1934: 75).

It also resulted in the emergence of the concept of a somewhat planned commercial economy in the UK (Gibbins, 1897). This approach was closely linked to the success of the UK, from the start of the Industrial Revolution (Hobsbawm, 1968), in terms of the strength of its domestic markets, the potential of export markets and the support for commerce exercised by government. Indeed, the cost competition impact of the Industrial Revolution upon, for example, the cotton industry was exemplified by the ability of the textile manufacturers of Lancashire to become, by the mid-nineteenth century, more cost-effective than the village-based weavers of India (Ward, 1994). However, the same cotton firms disappeared a century later, their demise attributed to international competition and the debt load of owners (Sayers, 1967), the latter being a key feature of private equity capital.

Interestingly, these factors were recognised by Porter (1990) as among those most closely related to successful national development. Hobsbawm (1968: 49) also argued that at that time Great Britain 'was prepared to subordinate *all* foreign policy to economic ends'. This view was supported by Williamson (1931: vol 1, 456), by quoting a comment by Young that the principal driver of growth within the British Empire 'was neither Lord Rockingham nor Lord North, but it was that baleful spirit of commerce that wished to govern great nations'.

The emerging strength of private equity and its freedom to gather large amounts of investment capital and select the most desirable financial targets represents the revival of an old force in international finance; a high value of private capital held in a limited number of hands. Since the repeal of the South-Sea Bubble Act in 1825, legislators have worked to limit the excesses of corporate behaviour and to protect investors from themselves. Private equity has many interesting features; it is legal, silent, has no particular corporate stance or public policy, it is not usually contained by national boundaries, generally has no stock market reporting requirements and has very limited transparency. Private equity investors are likely to be very demanding and expect financial success, but they are also their own watchdogs, auditors and beneficiaries of the results of private equity forays. Could the current popularity of this investment format be a result of the corporate restraints created by events such as those experienced by Enron and Worldcom? The most important reform involves the Sabanes-Oxley legislation in the US, alternatively entitled the Public Company Accounting Reform and Investor Protection Act of 2002. Legislators and regulators have been busy revising public company reporting standards and raising the responsibility requirements for accountants, auditors and board members of public corporations. But to what gain? To encourage a shift in investor focus from the stock market to private equity transactions while the regulators show the public they are containing public corporation excesses.

Private Equity and Contracting Out

Thus far, the link between private equity capital and contracting out may appear to be quite distant. However, in some jurisdictions, the two have become inexorably entangled in financial, legal and contracting predicaments and opportunities. The first link comes from the development of PPPs - increasingly complex and expensive infrastructure projects established on a build-own-operate contract with a life of up to 30 years. PPPs are technically sophisticated, financially complex, legally intricate and politically complicated. It has been noted that a leveraged funding model has been used as a private financing vehicle. Is this a private equity venture? Applying the definition of private equity capital discussed earlier in this paper, this would seem to be the case. A private company structure involving debt financing and supported by private capital also ensures that very little financial information about the venture is available. A curiosity is the ability of government to outsource large scale infrastructure using a non-transparent contracting model. While a government may provide a detailed account of its dealings with its private equity partner, this openness does not need to be reciprocated when in the hands of a private buyer.

Perhaps the second link relates to the nature of a market economy; a feature of capitalism which may be threatened by the contemporary rise of private equity. A recent press release by ABN AMRO shows that the bank has 'made a EUR 2 billion long-term commitment to be invested in mid-market buy-out opportunities in the Dutch, UK and Nordic markets. Through these actions, ABN AMRO has further reduced its active involvement in its private equity investment management activities, particularly buy-outs, while continuing to benefit from the very good returns that the business has proven able to generate' (Anon, 2007). An investment portfolio of this size is likely to have a differing impact on the Nordic markets than the much larger Netherlands and UK economies.

Even more significant, arguably, is the investment in the Blackstone Group by the Chinese Government (Sorkin & Barboza, 2007), giving a competitor nation a stake in a significant private equity partner. Similarly the sale of Alltel, a US telecommunications company, to private equity firms shifts a major corporate entity away from public view. Is this move against public interest? Can it lead to greater concentration of ownership away from regulators' eyes?

Apart from the scale of investment, the focus on 'very good returns' is significant and typical of private equity investment. Share market transactions usually attach strict reporting requirements whereas private equity may have no such constraint in many jurisdictions. A private equity fund can discretely manage a large amount of funds without disclosing its sources. It acts on behalf of principals - the owners of the private capital - and the only guiding ideologies may be to achieve 'very good returns' and 'minimize long term risk'. As private equity capital investments increase, they may impact the stock markets and the commercial market in which they intervene. By moving a public company from the stock market, private equity investors reduce the stock market competition. If private equity can acquire multiple organisations in an industry, then the competitive market is reduced.

Milton Friedman (1982) has made much of the need for citizens to have the freedom to choose the economic system they desire. Stiglitz, (2002) attacked this notion, noting the

negative impact on employment arising from the liberalisation of trade. His position is supported by Davis, Lyons and Batson (2007) who outline the plight of workers in Mexico and China as their circumstances are worsened by globalisation. In each case the concentration of ownership, at a national or regional level, is a significant feature. But the question must also be asked: At what point will the contraction of internal competition result in the collapse of competitive markets?

Farazmand (2001: 12) expects that foreign investment will need government intervention where 'hostile foreign buyers ... enter the market and buy shares and raise problems for public policy and management'. However, while there have been some attempts to rein in the reach of private equity capital, the outcomes have been limited. This should not come as a surprise when one considers the scale of existing privately held institutions which, in the US for example, range in size up to 151,000 employees (Reifman, 2007). Furthermore, these firms occupy a position of significant influence in their industry. Examples include the business services firms of PricewaterhouseCoopers, and Ernst and Young (Reifman, 2007), the farm products firms including Cargill and Murdock Holding Company, and the grocery stores of Publix Super Markets and Meijer.

There is also an interesting interplay between the competitive needs of capitalism and the rise of democracy. If capitalism is a 'social and economic system in which individuals are free to own the means of production and maximize profits' (Bannock *et al.*, 1998: 52), then private equity capital appears to meet the definition. However, a market system will struggle to be a 'social and economic' system if it has no competitive environment in which to operate. The Mercantile era discussed earlier, which existed in a time of subsistence economies where ownership was concentrated among a few large corporations and significant members of the ruling class, was eventually related to the gradual emergence of social unrest. It would be naïve to assume that societies which returned to such concentrations of capital could do so completely peacefully. It is interesting to reflect on the Marxian assumption that capitalism would be overthrown by exploited labour (Bannock *et al.*, 1998). Perhaps it will be private equity capital, exploiting all the benefits available from contracting out and the ability to invest at will, that may lead to a sharp contraction in the notion of the market economy and the wealth of the average individual. Korten (1995) raised questions about the capacity of corporations to rule the world, yet perhaps it is the private equity consortium that will place capitalism, and 'freedom to choose', at risk.

Conclusion

The emergence of equity capital as a global economic force is seemingly in its early days. However, it and the contracting out process share an important characteristic: the shift of business activities from transparent or regulated corporate behaviour to an opaque business mode, where the activities are conducted without adequate public scrutiny and where individual private equity ventures, have a secret governance mode. While contracting out has become commonplace, especially between public and private sectors, the risk for governments lie in the substitution of non-transparent privately financed activities for previous arrangements which are open to public scrutiny. In the case of private equity arrangements, the risk for society lies in the potential for non-transparent

corporate activities to attain a dominant role in the private sector economy. All the regulatory work of the past two hundred years, and more recently the development of legislation such as the *Sabanes-Oxley Act*, 2002, will be wasted. The owners of aggregated private capital will seemingly be able to indulge their investment desires without the protection of society by governments. It is this latter possibility that was one of the three tenets of government that were espoused by Adam Smith (1776); the first role of government is to protect a society from the envy of other peoples, the second role is to protect the members of a society from each other. Legislators may need to move swiftly if they are to minimise the rent-seeking excesses of private equity capital.

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Notes

¹ This source would not normally be used but its open, public access suggests it reflects current, general usage.