Capitalism Without Capital

For most of the 20th century the market leaders in corporate America were big corporations that spent large sums of money in tangible assets. They built things like refineries, manufacturing plants, and stores. Think of companies like Standard Oil, AT&T, Sears, and General Motors. For these companies to continue to grow they had to re-invest in these capital investments—new plants, new stores, new machinery.

The corporate titans of today, however, are very different. They invest largely in intangible assets—brands, processes, product design, research and development—things that you cannot touch. Consider Microsoft, which, as of this writing, is the most valuable company in the U.S., with a market cap of almost $850 billion. On Microsoft's balance sheet there are traditional assets of about $36 billion, or just 4% of its market value. In the 21st century the American economy has gone largely from a tangible economy to an intangible one.

A recent book by Jonathan Haskel and Stian Westlake, *"Capitalism without Capital: The Rise of the Intangible Economy"* explores this shift in our economy and explains what makes intangible investments different. The authors argue that "understanding the steady move to intangible investment helps us understand some of the key issues facing us today: innovation and growth, inequality, the role of management, and financial and policy reform."

What Makes Intangibles Different

The first part of the book focuses on the rise of the intangible economy and what makes intangible investment different from its tangible counterpart. In explaining the differences of intangibles, Haskel and Westlake came up with a convenient mnemonic, which they call the Four S's: scalability, sunkenness, spillovers, and synergies.

Scalability

Tangible assets are typically not very scalable because, as the authors point out, physical assets can only be in one place at one time. Intangible assets, on the other hand, are very scalable, as they can be used over and over, in multiple locations at the same time. Consider software and Microsoft: after the initial expense of R&D developing the first unit, the company can replicate unlimited units for virtually no cost.

This scalability is important because it has created very intangible-intensive business that have become enormous. Giants like Google, Facebook, Microsoft. And they have become so powerful because businesses looking to compete are in a difficult position. If Facebook is the best network to connect with your friends, why would you use MySpace? Haskel and Westlake declare, "Winner-takes-all scenarios are likely to be the norm."

Sunkenness

A sunk cost is a cost that has already been incurred and cannot be recovered. A tangible investment, such as a machine or a building, can be sold if need be. An intangible investment,

on the other hand, typically represents a sunk cost, as they are harder to sell and more likely to be specific to the company making the investment. The authors explain how this sunkenness of intangible investments matter because these type of investments can be difficult to finance, especially with debt.

Spillovers

Another important characteristic of intangible investments is that they tend to generate spillovers—the tendency for others to benefit from what were meant to be private investments. Think of ideas and R&D: they are copied every day. When Apple came up with the iPhone it didn't take long for other smartphones to start looking just like it.

Synergies

Intangible assets also tend to have valuable synergies with other intangible investments. Haskel and Westlake give the example of the iPod in explaining the power of synergies: Apple combined its MP3 protocol, miniaturized hard disk design, design skills, and licensing agreements with record labels.

These characteristics are not necessarily good or bad. They are just different from the way tangible assets behave. And if our economy is heading more and more into the direction of increases in intangible investment, it is important to understand how they work and what impact they can have in our society.

Consequences of the Intangible Economy

The second part of the book discusses the consequences of the rise of the intangible economy. The authors argue that the rise of intangibles help in part explain the current state of secular stagnation and the rise in inequality.

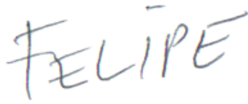
Haskel and Westlake persuasively argue that the synergies and spillovers of intangibles have created increases in inequality of income and inequality of wealth. They state, "The synergies and spillovers that intangibles create increase inequality between competing companies, and this inequality leads to increasing differences in employee pay." They continue, "Thriving cities are places where spillovers and synergies abound. The rise of intangibles makes cities increasingly attractive places to be, driving up the prices of prime property. This type of inflation has been shown to be one of the major causes of the increase in the wealth of the richest."

The authors also address how investors should approach allocating money in an intangible economy. The first thing an investor needs to understand is how a firm is building its intangible assets. In this regard, investors need to be well-versed in accounting rules, as intangibles can be expensed or capitalized, depending on different circumstances. Investors that devote the time and energy to understand the potential of different types of intangible investments will be able to generate good returns. Haskel and Westlake point out that, "certain types of intangible

investment tend to be systematically undervalued. This suggests there are opportunities for investors who can identify good intangible investments and back companies that make them over the medium term."

Conclusion

Capitalism Without Capital is an eye-opening read. It is not for everyone, as a basic understanding of economics is needed to grasp its concepts. Nevertheless, it should be required reading for those that want to understand the rise of today's intangible-intensive corporate behemoths and how this new economy is affecting investing, public policy, and even politics.



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