

Europe as an Economic Location

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Introduction

Contrary to popular belief, Europe, as an economic entity, is operating from a position of relative strength in the world. The difference in economic growth rates, with the US for example, is heavily distorted in favour of the US due to differences in population growth rates and statistical anomalies. The higher US growth rates since the recession of 2001 should be largely contributed to a totally unprecedented - and many would argue irresponsible - Keynesian financial injection into the US economy. Substantial tax reductions, the lowest interest rates in history and, related to the latter, a feverish housing market, have all conspired to secure ongoing growth in consumer spending. Increased government expenditure also has fuelled economic growth but the contributions of private investments and exports, have lagged by a substantial margin.

Looking at the European private sector, its competitiveness on world markets is beyond question. The WTO reports a 45% share of Europe in the world's interregional exports. As a result Europe maintains a trade surplus with the rest of the world and a large and structural trade surplus with the US. It is expanding aggressively and successfully in growth markets such as Eastern Europe, India and China. European companies are building these positions despite the very substantial advantages their American competitors enjoy on their home market, which taken together, provide an ideal launching pad for exports and foreign investments. To these advantages belong: one language, one legal system, fully integrated markets for goods and services, structurally higher R&D spending, the world's most advanced ICT and financial service industries, an abundance of venture capital, flexible labour markets and a widely supported political choice for economic growth over social cohesion.

European companies are doing well despite significant competitive disadvantages. To an extent these mirror American advantages. The EU remains the home of 27 legal systems and 27 tax codes, almost as many languages, different labour laws and practices, different roles of regional and local authorities, different forms of environmental protection, different consumer protection policies, and so on and so forth.

In addition, throughout the region European companies still have to overcome a range of barriers to market entry. European economic integration is far less advanced than generally assumed. Substantial growth of exports of goods within the EU, the introduction of the Euro, Basel II and the financial services action plan have been success stories, but otherwise progress has been excruciatingly slow. Europe is still rife with informal resistance to foreign influence. Connections between local authorities and local companies remain both invisible and influential as exemplified by lax implementation of EU public procurement rules.

Investment and takeovers across country boundaries are still the exceptions to the rule. European national economies have evolved into service economies but exports of services are still at pitiful levels. The watered-down version of the service directive approved 50 years after the Treaty of Rome is hardly providing a fresh start.

The overall effect is that very few companies operate on a European scale, which is to say with significant sales and/or production units outside their home countries. This becomes apparent by looking at the number of companies with a European works council (for consultation with the management on corporate strategy and labour-related matters). A works council is obligatory if the company is active in three countries or more, with a minimum of 100 employees per country and a grand total of 1200 employees. In 2004 only 2000 out of millions of European companies met those criteria.

Looking on the one hand at the array of competitive disadvantages European companies face and on the other at their excellent performance, the search must be on for considerable European advantages to help explain this anomaly. These are most likely advantages that hitherto have not been recognised as such.

Unveiling such advantages will create new perspectives for policy development. It is a well-established business principle that it is often more economical to enforce what is already strong than to shore up what is weak. This lesson should be applied to European policy making. Europe's agenda should be expanded with the identification, defence and strengthening of the strategic advantages of European economies and the European private sector. It is to be expected that in this largely unexplored territory, EU proposals will meet far less political and social resistance than the removal of presumed structural barriers to economic development, which is now the mainstay of policy development. This new approach could add significantly to the momentum that the Commission is trying to create in the context of the rejuvenated Lisbon process.

In this paper six strategic advantages are suggested that deserve to be researched in depth. By means of illustration some of the repercussions for EU policy making are explored.

Avoidance of the shareholder model

The Anglo Saxon way of conducting business can be characterised in the following way. There is only one unequivocal corporate objective: the pursuit of shareholder return on investment: the largest possible increase of the share price within the shortest period of time. A single official provides leadership: the chairman and chief executive officer. In order to operate as closely as possible to the market, corporate decision-making is heavily decentralised to divisions, to business units and eventually to so-called product/market combinations and the individuals who face the customer. This has to be accompanied by very tight financial controls and by substantial financial incentives to keep personal and corporate objectives aligned. Believe in markets is deeply engrained in dealing with the outside world and in allocating scarce resources throughout the company.

This shareholder model has very considerable drawbacks. Just focussing on one feature, the single corporate objective already reveals major flaws. There is no relationship between the market capitalization of the company (share price times the number of shares) and its economic value: the sum of all future positive and negative cash flows, year by year properly

discounted for risk and uncertainty while taking the cost of capital into account. As a result, decision making regarding supervisory and management control (in the context of mergers and acquisitions), capital and talent is distorted. Moreover, the premise that a persistent, preferably double digit, growth in profit per share will be rewarded by the stock markets is false. There is overwhelming prima facie and empirical evidence that this is not the case. The conclusion must be that a dubious objective is being pursued in the wrong way. Finally, the pursuit of constantly increasing profit per share, in combination with the shortening of CEO contracts and sharply increasing variable pay linked to profit per share (or even worse, to the share price) skews policymaking. The emphasis will be on policies that have a measurable effect before expiration of the management contract. This explains the popularity of share buy backs, cost cutting and acquisitions to reduce costs further, often at the expense of future cash flows. It also helps to explain the reluctance to commit to large and complex investment, to partnerships and to R&D, all steps that would create substantial economic value but at the expense of short-term profits. The ultimate paradox is that economic value is destroyed, or not created, in the interest of the shareholder.

Despite these and other flaws, Westerly winds remain forceful, taking the shape of pressure exercised by American and British investors, strategy consultants, investment bankers, financial analysts, credit rating agencies and financial journalists who are adamant that any other way of conducting business is inferior. As a result, more and more listed European companies have embraced this model. A very weak model is apparently strong enough to replace the hitherto dominant stakeholder model.

However, the vast majority of European companies are family owned and as a result they escape the straightjacket within which their American and listed European companies have to operate. This amounts to a considerable strategic advantage.

Europe's agenda needs to focus on the creation of economic value as a sound and practical guide in regulating and stimulating the private sector. The microeconomic pursuit of economic value is consistent with the macroeconomic aim of sustainable economic growth. Policies to help companies achieve profit growth will not achieve the desired result and may even be counterproductive. All presumed causal connections between, on the one hand, profit growth and on the other, investment levels, job creation and R&D expenditure, have been severed some time ago. Moreover, many EU, EIB and national programmes to stimulate innovation by means of subsidies, below-investment grade equity and the like, could fall victim to corporate pursuit of profit per share growth. Those need to be reviewed.

Diversity in conducting business

Europe enjoys another crucial advantage in the form of a wide range of enterprise models, from co-operatives to small businesses and from state enterprises to large conglomerates. Each model shows considerable national and regional variations. All these individual non-listed companies have considerable freedom in choosing the most appropriate form of governance and management, organisation structure and culture, as well as planning and remuneration systems. They can cater to the requirements of the markets they serve, the technologies they apply and the labour markets on which they depend. Such flexibility translates into considerable economic advantage, particularly because the requirements of companies change from one stage in their development to another.

The best way to capitalise on this flexibility in governance and organisation is to create transparency, to encourage Europe-wide competition between various enterprise models and to support research into, and experimentation with, new models.

Fortunately, the European Commission has already focussed attention on the major contribution made by European co-operatives and small businesses and has introduced a number of action programmes to strengthen their respective positions. They range from the facilitation of cross-border cooperation of co-operatives to help with the financing of high-tech start-ups.

On the legal front there are also a number of favourable developments under way. Legislation in some European countries to enable companies to use alternative European legal entities, such as French SA's, Dutch BV's, and German GmbA's, is fortuitous. The choice of Allianz for the European legal corporate entity has lent this option much needed credibility. A new EU directive that sets basic standards for European corporate entities provides a framework that will make more variety possible.

Cross-border mergers, already actively pursued by the Commission, also encourage competition between enterprise models and give rise to new models of which Air France/KLM is an example

More can be done. As requirements of companies change when they grow and mature, more attention should be devoted to the facilitation of migration from one legal entity to another. There is also a real demand for the legal structuring of European-wide partnerships.

Of particular importance are companies in the new member states. The inroads of American and British economic advisors, investment banks and strategy consultants have been considerable - access to experts with alternative views on business development needs to be facilitated.

A wide range of sources of finance

Although European exchanges also act as conduits for pressures exercised by shareholders, there is still a significant degree of difference between the supervision and management of European and American bourses. Moreover, given the larger role of institutional investors in trading on European exchanges, a modicum of common sense shines through in many deals, as the financial community has to cater to these large customers with commitments in a distant future.

In this light, the takeover of Euronext by the NYSE has been a considerable setback. It is said that the federation model of Euronext has been secured but that remains to be seen. Marketing and sales efforts to draw more individual investors to the exchange will increase. This has a number of implications: more irrational and ill-informed trading, increased opportunities to manipulate stock prices at the expense of the small shareholder, more volatility and as a result even greater discrepancies between the market capitalisation and the economic value of companies.

Moreover, American bourses are far more aggressive in trying to increase their share in corporate finance. They have every intention to take full advantage of the more benign regulation of European stock markets. The larger the total market capitalisation of the companies on their big boards, the larger the lucrative markets for options and derivatives.

A world emerges in which the whole financial community has an interest in stock price volatility. Bourses and intermediaries increase their turnover, while investments banks and private equity capitalize on the exit and break-up opportunities that under and overvalued companies provide. Contrary to their public pronouncements, individual companies also benefit from the volatility of their stock price and the resulting higher turnover. The higher the turnover, the greater the exit opportunities for edgy short term investors and the more they feel confident to step in. The higher the turnover, the more financial analysts will follow the stock, the more the company will stay in the public eye, and the combined result of all this is a higher share price. It is telling that over the past five years the average time shareholders held a stock was reduced from five years to nine months.

In playing defence, the Commission and the ECB have a major role in preserving and stimulating diversity among European bourses. Fortunately, many European bourses are more efficient than their American counterparts and all have the good fortune of using the most stable currency in the world.

In light of this analysis, the fact that European companies finance most of their investments from their cash flow and that from the additional capital only 25% is provided by the stock markets (compared to 75% of US companies) should be seen as a strategic advantage. The greater the role of internally generated funds the more independent the company is.

As already indicated, the most fundamental contribution the EU could make is to help companies increase their cash flows, and not their profits. Cash flows are driven by increased revenues and by improvements in productivity. In the European context this means: more intra-community trade, and more transfers of soft and hard technology in the form of investments across EU country boundaries. The daily grind of lifting small and large barriers to trade and investment by the EU deserves to be more appreciated and would benefit from the allocation of more resources.

A second increasingly important way to circumvent bourses is the stimulation of business partnerships. Family companies are well versed in using this route as an alternative source of finance. Rather than focussing on cross-border mergers and acquisitions, where in 80 % of the cases economic value is destroyed, the EU should facilitate cooperation among European companies and help them achieve growth and flexibility at lower risk.

In principle, bank loans and private equity are superior to stock market financing. Creation of economic value takes centre stage with all the associated advantages for the company. Banks focus on interest coverage, the cash flow divided by the annual interest payments. Private equity houses look for increased revenues and better use of capital. In both instances knowledgeable professionals join the management in the pursuit of value and it is therefore no surprise that companies that use private equity grow faster and create more employment than listed companies.

Recently, there have been far too many instances whereby private equity houses destroyed economic value. But instead of discrediting a whole category of investors, it would be much wiser to define the problems and to resolve them.

The EU could mitigate the detrimental impact of public equity on companies, by continuing its efforts to improve the transparency of capital markets and to increase competition among the providers of capital. In doing so, companies will be enabled to draw on a variety of sources of capital in their quest to lower the cost of capital, both in terms of the conditions and in terms of the degree of control that has to be yielded to banks and shareholders.

A supplementary approach is the stimulation of trade sales i.e. direct sales from one fund or company to another. In such instances sales and purchases are made by professional parties, representing strategic partners, banks, family holdings or private equity houses. In all instances buyers are looking for embedded economic value and for new possibilities to realise and to increase the potential of the company. This prevents value destruction for short-term gains.

The Basel II agreement, the enhanced role of the European Investment Bank, and the virtual completion of the Financial Markets Action Plan in general and the Financial Instruments Directive in particular are landmark achievements that could be built on.

Low transaction cost in an age of corporate networking

As mentioned, intra-European trade can still grow substantially. Moreover, EU wide corporate partnerships in all shapes and forms are required to combine expertise and assets, to improve productivity and to develop new markets and new products. As a result transaction cost, in the broadest sense of the word, become more and more important.

In the US business partners are allowed everything that is not explicitly excluded in law or by their contract. This legally and culturally enshrined premise, in combination with the peculiar ways case law is administered, produce a business world driven by antagonism - with control at a premium and cooperation a second-rate solution. Conflicts are often settled by litigation at very considerable expense. The cost of legal support is impressive and still rising. Compensation for damages and punitive damages have taken on grotesque proportions. Cases could linger for many years in an endless quest for relevant legal precedents and are given a broad scope for appeals on procedural grounds. The expense in the form of the distraction of the management and staff is difficult to gauge, but is easily a number of factors higher than the direct cost. However, the greatest economic damage is caused by missed business opportunities as companies and their shareholders become risk-averse and avoid promising areas for business development.

So far, European companies have enjoyed relatively low transaction costs. Partners are generally aware that building trust is a precondition for economic gain. Being reasonable and fair and acting in good faith are still valued. The legal systems on the continent provide contracting partners flexibility and protection, thanks to the civil code, which in modern times has clear advantages over case law. For example, the relatively strong legal position of the weaker of the two contracting parties is crucial in an economy in which large companies engage large numbers of small innovative companies in a variety of ways.

If and when their contract cannot resolve a dispute between partners, a professional judge will rule on the basis of the original intentions of the parties and their obligation to take the interests of each other into account. Punitive damages have only recently been introduced but appear still confined to gross negligence. In most European countries rulings can be appealed only once, settling the issue for once and for all within a reasonable timeframe. Increasingly, arbitration and mediation are being used to settle disputes.

Key EU policies have added benefits in this arena. In a completed internal market, increasing numbers of transactions, investments, alliances and takeovers will cement the use of the civil code in economic life. This should help to counter the inroads of British corporate and contract law on the continent and the aggressive marketing of large British law firms. Rational managers of continental companies should resist the choice of UK law as an unhappy compromise if neither partner feels uncomfortable going to court in the jurisdiction of the other. Much anxiety could be taken away by balancing the choice of the corporate law of the country in which one of the partners operates by reliance on a court of arbitration based in the country of the other.

The recommendation by the High Level Group to give the EU more flexible legal instruments than the directive, in the form of secondary rule in the form of standards for best practice and formats for legislation is a further step in the right direction.

Culturally equipped to pursue open innovation

There is far too much emphasis on the patent system as a way to entice companies to invest in R&D. The reasoning is that only proper protection of intellectual property will tempt companies to use shareholder money in ventures with a highly uncertain pay-off. The first implication is that interesting lines of research that could add substantial economic value are abandoned if findings could not be legally protected. In addition, the patent system has been degraded to the exploitation of legal definitions of novelty and originality. It is a world in which the evaluation of opportunities to obtain a licence from a potential partner starts with the exploration of ways to circumvent the patent on which the license is based. A world in which far too many companies try to obtain nuisance value by taking out exclusive licenses and trading them to the highest bidder, or to create havoc by challenging patents on dubious grounds, assuming that sooner or later the owners who have businesses depending on these patents will buy them off.

The original and more important function of the patent system is the provision of access to what the world has learned and this at reasonable expense. The thousands of small and large licensing deals that are closed year after year measure its success. There is for example no new step in biotechnology that does not depend on a string of technology platforms, procedures and products developed in the past in academia and by competitors. It is still the case that in this industry no company large or small will refuse licenses to reputable companies with sound plans.

The question is how to capitalise on the 4 000 000 patents in the world and the 800 000 patent applications that are annually added to the pool. Europe is well placed to turn the patent system into the cornerstone of an open innovation policy.

In laying the foundation for a truly open system there has never been more reason to remove the political barriers that have plagued the further acceleration of the growth of European patent system up to today. A community-wide patent and a single patent court must be introduced at short notice. The cost of translation of all community patents other than in German, English and French into other official languages must be borne by the EU. It is a price that cannot be escaped, as access to all new findings wherever done in Europe is in the European interest.

Electronic access to patent texts is already easy, but patent language is arcane and requires a combination of business acumen and scientific insight to appreciate its potential. The EU could increase transparency by adding layman summaries to patents. Patents are of course a long way away from reliable new technologies. It is therefore important, within the constraints of commercial conditions of exclusivity and confidentiality, to make information available about the ways licensees have put a patent to good use. This is, at a minimum, in the interest of the licensor in his quest for more licensees. At a deeper level it will stimulate innovation by helping findings to cross sector boundaries. Examples of technologies with a broad use are pneumatics, pumps, logistics and in particular computer soft and hardware. The name of the game in stimulating medium-term economic growth is the creation of new combinations of tested technologies, services and trademarks

The innovation exchange networks sponsored by the European Patent Office that already go in this direction deserve more attention. There is also commercial software on the market that improves access to applications, but at a price that is prohibitive to most small companies.

Furthermore, Europe should play to its strengths as the world's leader in design and the sophisticated way it protects designs and trademarks. Enabling entrepreneurs to seek and find protection for combinations of different forms of intellectual property is an enticing prospect.

Open innovation calls for the stimulation of trade in intellectual property within the EU. This goes to the core of the internal market and the EU should do everything within its considerable powers to create a well functioning market including markets for auxiliary services like scientific conferences, trade fairs, legal support and conflict settlement. This will automatically serve the export and import of intellectual property to and from other regions of the world. As matters stand European companies file more patents in the US and Japan than vice versa. The 60 billion or so that is presently exchanged between regions in royalties and licence fees is only a modest beginning.

Home of the world's largest players

Large companies play a far greater role in transforming innovation into economic growth than generally assumed. They own most of the world's intellectual property, patents, designs and trademarks. Large companies have the financial resources to translate intellectual property into products and services that add economic value. They provide the continuity that is required for persistent step-by-step improvements. They are masters of marketing and control the sales and distribution channels. They can mobilise any team of specialists on all topics at short notice. They have experience in managing networks of companies and institutions. They dominate world trade and the transfer of technology. They are partners in designing industry regulation in the interface of economic, social and business interests.

The shareholder model discourages innovation in many different ways. Shareholders are risk adverse and management has to follow suit. Following the competition is safer than breaking away from the pack and facing the possibility of falling behind. Benchmarking leads to convergence of corporate strategies and less innovation. The customer is king, but powerful business units defend their interests at the expense of the customer of the future. Internal competition, supposed to yield new ideas and to select the best, manifests itself in the quest for power to keep and extent control. Bonuses and options are geared to financial and operational targets. The adage is that only what is measured gets done, hardly conducive to innovation. Distrust is deeply rooted and the cooperation required for innovation seems to be in nobody's interest.

In response, many politicians and companies have nailed their colours to the corporate responsibility mast. It appears to be the only way to resist the shareholder model. The EU Commission seeks to appeal to reason and good citizenship. There is a logic to the point of view that when the Commission does everything to support entrepreneurs and enterprises, a reasonable commitment to employment would not be too much to ask.

Unfortunately, the record shows that even for companies that see themselves as the vanguards of the CSR movement, the impact on corporate decision-making where it matters, in making top appointments, in merging, in investing, in rewarding their employees, is indiscernible. To add insult to injury, where Enron has become the symbol of the failings of the shareholder model, BP, the winner of all CSR prizes in the world, has now been exposed as a company that proved unwilling to provide a safe working environment for its employees.

The battle is on for the soul of the 60 of the world's largest 100 companies that are based in Europe. Will or will they not remain part of the social and economic fabric of Europe, maintaining their own and tailor-made ways to conduct business? Europe's large, generally very successful family conglomerates have a special responsibility in setting standards that other large companies could emulate. The fact that Europe is the recipient of 60 % of the world's foreign direct investment bodes well. The fact that large European companies seek their expansion in Europe is encouraging. The EU pressing to augment the potential of the common market as indispensable as ever .

In conclusion

The suggested new directions are intended to advance the private sector and to create the sustainable economic growth Europe needs to develop its own very competitive brand of capitalism, including the pursuit of its political, social and environmental objectives. The logic that underpins each of six propositions needs to be tested and the potential for improvement properly assessed. The effects of existing EU policies on Europe's true competitiveness need to be understood better. Where necessary amendments will have to be made, but the emphasis should be on the creation of new EU instruments to strengthen Europe's strategic advantages.

