The emergence of European capitalism

By Donald Kalff

Presentation to the "Denkraum Europa" seminar, organized by the Société Europeene de Culture in Berlin on May 26, 2017

Many thanks for the opportunity to share with you my views on the future of capitalism in Europe. This subject is obviously very much intertwined with the fate of our liberal democracies and the next phase of European integration. It is already a cliché that we have until the next French presidential election to get it right and to re-engage those who have fallen for the temptations of ethnic nationalism.

We need higher economic growth and we need to restore confidence in our business leaders in a world dominated by financial markets.

We know that only 15 % of all the money in the world is tied up in economic activity, the rest is packaged and repackaged in products that are traded between banks and other financial institutions.

Financial capitalism is a perverted version of a system that has served Western Europe extremely well since World War II and more recently has brought wealth and stability to Southern and Eastern Europe. Financial capitalism originated in the US and the UK and liberalization of the world's financial markets paved the way for its expansion. Return on capital is not the dominant objective, it is the only objective. In its pursuit, everything not explicitly forbidden by law or excluded by contract is permitted.

The forces aligned to defend and expand financial capitalism are formidable. Greed, fear and herd behaviour stand in the way of change. Political and cultural forces are necessary but by no means sufficient to counter what is a conspiracy without conspirators.

Also, a greater role for governments and global institutions and more regulation of financial markets will yield very little. Bringing the banks under control after the financial crisis only yielded mixed results at great expense to the taxpayer and the banks' customers.

The main thrust of my presentation is that there is an alternative route. Many stars are now aligned to enable Europe to break away from financial capitalism. There is every reason for optimism.

We should capitalise on the fact that financial capitalism is its own worst enemy because its destroys economic value built in the real economy. Managed funds have consistently lost money over decades. Listed companies have let their shareholders down. Uncertainty emanating from the financial markets regularly paralyses the real economy. More about this later.

Large parts of the economy on the continent never succumbed to Anglo-Saxon views on capitalism and the tide is now turning.

Brexit and the indifference of the US leadership to Europe are political landslides that will reduce pressure to fall in line with global, read, financial capitalism.

I will argue that a new and highly competitive form of capitalism, is already there for those who want to see it. Our task is to turn the spotlight on it, protect it and expand it. Only economic forces will be powerful enough to counter financial capitalism.

I am not a macro economist, a political economist or an economic sociologist. These are all fields that have contributed very little to the analysis of the predicament we are in. I believe that a **micro** economic perspective is required to get to the root causes of the malaise and to identify remedies.

I will now take you to a world with which most of you are not familiar. The world of large enterprises, from icons like Shell and Roche to newcomers such as Facebook and Tesla. Why do these companies play an indispensable role in modern economies?

It is because they spend considerable sums on R&D. They develop products, or buy them from smaller companies, identify and develop markets and build highly efficient worldwide production and supply chains. They can tackle large scale, technologically advanced, high risk, projects. They set standards that create whole new classes of desirable products. They are the cradle of management talent and they provide, directly and indirectly, high quality employment.

Nobody believes that the vexed problems of our time, lack of political stability, global warming, overpopulation and the perpetual Third World health crisis, can be tackled efficiently and effectively without the support and active involvement of large enterprises.

It is therefore understandable that, in the wake of the breakdown of the financial system in 2008, central banks and governments, facing a deep recession, resorted to policies to accommodate the private sector in general and large enterprises in particular. Central banks lowered interest rates to the maximum extent possible. Many Governments lowered effective tax rates, made labour markets more flexible, and pushed deregulation. All this was supposed to trigger innovation, investments and export growth.

Yes, economic growth has returned, but at what price? It was achieved at the expense of future generations that must service mountains of private and public debt, it delayed Southern European economies adapting to the realities of life and laid the foundations for a new round of financial instability.

Worse, these gargantuan efforts were largely wasted. Let's look at the top 500 listed companies in the S&P index. According to many the best enterprises in the world. How have they performed since the financial crisis of 2008?

Growth of investment has been lackluster and the returns on past investments have even shrunk. Export growth has declined. The share of new products as a percentage of total revenues has stagnated. We have witnessed one scandal after another. Be this as it may, the most depressing finding by far is that productivity growth has slowed down. Not one year, but year after year.

Since improvement in productivity is the only source of genuine economic growth poor performance in this department is highly disconcerting. Particularly, because the modest gains in productivity were delivered by only 5 % of the companies. 475 companies, led by the best and the brightest, have been treading water.

Something is seriously wrong when enterprises cannot apparently capitalize on the most business-friendly political context in the world, huge homogenous and integrated markets, one legal and one fiscal system, only two languages, deep capital markets and the best business schools in the world. Advantages European companies can only dream of.

My diagnosis is that financial markets have put enterprises in a straightjacket that has made value destruction all but inevitable. It also provides an explanation for the decline of productivity that has so far eluded politicians and economists. Here the role of stock markets is essential as they serve as conduits for the financial markets to ensure that companies serve their interests.

The Anglo-Saxon Enterprise Model

The villain of the piece is the so called Anglo-Saxon Enterprise Model. Superficially a very attractive way to go about business.

However, the key characteristics of this model are also its fundamental flaws.

In this model, the enterprise's objective is to optimize shareholder return on investment, being the sum of the dividend stream and the appreciation in the shares. Financial markets have imposed the assumption on enterprises that a constant rise of profit per share will be the most effective way to reach this objective.

Plausible as its sounds the causal connection is missing. Share prices are largely affected by factors unrelated to the performance of the individual enterprise. The so called `Efficient Market Theory` that postulates that all relevant information about the company is reflected in the price of its shares, has been well and truly proved false. Stock prices are not fair and do not reflect the value of an enterprise.

The implication is that all the efforts and all sacrifices being made to improve profit per share will not produce the desired outcome. Capital and talent are being wrongly allocated on an unimaginable scale.

Moreover, improving profit per share implies of course increasing the numerator and decreasing the denominator. The quickest way to increase profits is by cutting cost which is synonymous with a reduction in manpower. It is a dark secret that those programmes hardly ever succeed and that is before all the expense of cost cutting and the unintended consequences are considered.

Pushing profits also puts constant pressure on investment. Accounting rules provide that the inevitable early losses caused by investments are at the expense of corporate profits. Accounting rules also lead to a preference of acquisitions over investment as acquisitions can be put on the balance sheet and can be depreciated over time, doing less harm to short term profits. Where investments are risky, acquisitions fail in 60% to 80% of all cases.

The concentration on profit per share also explains the frantic buying back shares, lowering the denominator. In real life, this amounts to an admission by the management that it is unable to identify value creating investments.

All three popular policies are fueled by the remuneration packages of the management, whereby up to 80 percent is variable and to a large degree tied to profit per share or the share price itself.

The second key characteristic is the trust in individual leadership. The rationale is that only individuals can inspire, that only individuals can act quickly and decisively and that only individuals can be held accountable.

This focus on single leadership is very much in the interest of the financial markets. Individuals are highly sensitive to the prevailing views amongst their peers and superiors. Nobody comes up through the ranks without embracing the central tenets of the Anglo-Saxon Enterprise Model. In addition, individuals can be put under pressure and when radical change of the course of the company is required the removal of a single person suffices.

Here is the basic flaw in this argument. Over the years much sound social psychological research has showed the limitations of individuals to process and analyse information and to take decisions on that basis, problems augmented by our overconfidence in our capacity to predict.

We are only aware of a very small portion of all the emotions, fears, desires, assumptions and facts that we hold at any point in time. We have no control over what rises to the surface. Our judgements are clouded by an astonishing range of biases and stereotypes, our confidence in our skills to read human behavior and to convince our fellow man have no basis in fact.

Not to mention narcissism and other forms of psychopathology that are a serious problem amongst CEO's.

The victim is the quality of decision making, with enterprises making commitments that cause the destruction of economic value.

The third key characteristic is the reliance on target setting and control for each manager and each employee coupled to significant rewards and severe punishments. J&J used to have a policy called: three strikes and you are out, meaning that if you did not meet your target twice, the third failure was fatal. No longer. The new policy is two strikes and you are out. In short, management by fear. I also point you to a series of articles in the NYT about Amazon and its management practices.

It is all about offering shareholders the illusion of control, by focusing on financial and other quantitative parameters. Such systems are based on discredited concepts of learning and harm the motivation, the wellbeing and the health of middle management and employees.

In most listed companies the problem is compounded by the belief that internal competition about the means of achieving the targets will bring the best out of people. Is anyone be surprised by the lack of trust, a condition for cooperation, in turn required for innovation and value creation?

Summing up, the way enterprises are managed and the most popular policies cause considerable damage. This damage has now reached macro-economic proportions. If in 2014, the 500 S&P companies had invested one quarter of the capital outlay to buy back their shares, the US economy would have grown by 3,2% of GNP instead of 2,4 %.

So, what is the alternative for the Anglo-Saxon Enterprise Model?

The Rhineland Enterprise Model

In the months and years to come you will hear much about the rejuvenation of the so-called Rhineland model or in modern jargon, the Stakeholder Model. In this model, the enterprise has an obligation to pursue the interest of all parties that have a vested interest in the enterprise. This will be most unfortunate as this model also stands for value destruction. Let me just remind you that this was the preferred model for listed European enterprises until the mid-eighties only to be swept aside by the weak Anglo-Saxon model. Its shortcomings are multifold.

Embracing the concept provides openings to all comers, legitimate or not. At best a nuisance but not seldom escalating to cause serious distractions. More important is the fact that only the present stakeholders are represented, nobody comes to the rescue of future stakeholders.

Many interests are institutionalised, with power exercised without responsibility and accountability and often without knowledge of the real cost to the enterprise of meeting the demands. Once established stakeholders defend their positions vigorously, often serving a clientele that pines for short term success. Often, the management is left to juggle the very different viewpoints expressed by different stakeholders.

As a result, stakeholders constrain innovation and slow down decision making and I do not have to explain to a largely German audience that a large role for stakeholders in the governance and management of an enterprise comes with considerable risk. The bottom line is that an enterprise is considered a community of interests that are pursued at the expense of the enterprise itself.

The search is on for a different model and it is good news that under the proverbial radar European enterprises that operate on very different principles are flourishing. It is encouraging that we find them in different economic sectors, that they apply very different technologies and that they are in various stages of development. Norske Nordic is a fundamentally different company from GSK, so is Statoil from BP and Svenska Handelsbanken from Barclays and all three are far more successful than their British competitors.

What they have in common apparently works. I have labelled it the European Enterprise Model. Here are its main characteristics.

The European Enterprise Model

As properly reflected in corporate law, the European Enterprise is an independent entity. An economic actor that can engage in contractual relationships and that is accountable for its actions. It is not an instrument in the hands of its shareholders and not the servant of the special interests of the day. It is an indispensable institution that is the only true source of economic growth: an increase of productivity driven by the introduction of smarter working methods and by investments.

The European Enterprise strives towards so called economic profit which differs profoundly from accounting profit. It is nothing more and nothing less than the positive difference between all cash income and cash outflow irrespective of its source and irrespective of its destiny, now and in the years to come. In my definition, it also includes the cost of capital the enterprise employs to run its business and to make investments. Bank loans need to be repaid, interest payments on the outstanding debt need to be made as do dividend payments to shareholders.

All this is simple and basically household economics. Our income should cover all our daily costs and our investments in appliances, in transport and in our home. And we need to service our mortgages and any personal loans we might take out.

As the saying goes, accounting profits, the focus of financial markets, are a matter of opinion. They are subject to sometimes arcane accounting principles and easy to manipulate by the management. More importantly, accounting profits are very poor guide for decision making. For example, enterprises tend to back their most profitable units. Unfortunately, profitability is a very poor predictor of future profitability.

Cash never lies and provides a cascade of benefits. It is the dependable guide for decision making at all levels of the enterprise: operational decisions, decisions to prune activities and to start new ones, decisions to invest and to engage in partnerships.

Focusing on cash also implies a focus on the future as the value of the enterprise is the sum of all its future annual net cashflows, corrected for inflation. Focusing on the future helps enterprises to see more opportunities and increases the warning time for unfavorable developments. Its forces them to anticipate on legislation to come and to take “external” costs into account

Finally, focusing on cash and therefore the future helps anchor the enterprise in society at large. Advanced enterprises are keenly aware that they need to have a “license to operate” now and in the future from society. If this is withheld, their cashflows will suffer and their continuity will be endangered. Shell and Total felt the pressure to tackle climate change early on, ExxonMobil and Chevron much later.

The first responsibility of management and employees is to serve the enterprise and not its shareholders or stake holders.

Leadership of the European Enterprise is provided by a chairman, heading a modern day collegial management team. Only teams can control individual biases and stereotypes. The chairman prevents “groupthink”

Each member of the team has profound knowledge of the industry sector in which the company operates, and of the distinguishing competences and shortcomings of the enterprise. Shared and individual responsibility for the enterprise in combination with a variety of perspectives, but not a variety of interests, does wonders for the quality of decision making.

Competence and independence are essential for trust in the leadership and the granting of authority by the rank and file.

Entrepreneurship takes central stage as the leadership carries responsibility for innovation, for the design and development of new business models and for building of the organisation to support this. The aim is over time to bring the value creation by the enterprise to a structurally higher level.

It falls to the current organisation to optimize the value of the existing business models. First, by minimizing the inevitable erosion of value caused by the daily disturbances, due to mistakes, unexpected events and sheer bad luck. Second, by improving performance, given the available expertise and assets. The so called "multi factor productivity", the little understood sum of all improvements that cannot be attributed to new ICT, plant and equipment

Moreover, by investing in expertise and assets to increase the positive cashflow. Clearly, when the projected extra revenues are not higher than the extra costs (including the cost of capital) economic value is being destroyed.

Such contributions are only possible with a far-reaching delegation of responsibilities whilst the economic value perspective links individual performance directly to the prosperity of the enterprise. Freedom to operate, a clear "line of sight" between own contributions and the performance of the enterprise as well as room for craftmanship, the desire to produce quality for its own sake, underpin personal motivation and identification with the enterprise.

I urge you to look at Novo Nordisk, Statoil and Svenska Handelsbanken as trendsetters for other companies and I am confident that you will conclude that the principles that I have outlined are not high-minded ideals but prescriptions for real life success.

Conclusion

In EU 27, we are facing the unique situation that individual shareholders, employees, taxpayers, consumers and pensioners have a common interest in enhancing the performance of large companies. This is in line with the blurring of the distinction between the political left and the right. New alliances can be forged to change the rules of the game. Trust in capitalism can only be restored when entrepreneurs take the helm of large enterprises, bring the functioning of their companies to a structurally higher level and so contribute to economic growth.

Of course, the economic and political context in which these efforts will be made is of crucial importance.

The EU27 is the natural home for the European Enterprise Model, providing fertile ground for the following reasons

75% of the financing of US companies takes place with the stock market as intermediary. In EU27 only 25% as banks still play a major role in corporate finance and banks are cash oriented. This provide a degree of protection against the financial markets that is worth having.

EU27 is the largest exporter in the world as well as the largest importer. E27 enterprises can benefit from an unrivaled web of trade agreements

Enterprises in EU27 will experience a tail wind as markets for goods services and labour, the largest markets in the world, will integrate further.

European values such as reasonableness, fairness and moderation, that are enshrined in law are highly conducive for modern enterprises that depend on cooperation with a variety of partners to innovate and grow.

Conversely, the European Enterprise has much to contribute to EU27. Enterprises focused on value creation help to create economic growth, provide safe and inspiring work environments and are sensitive to society's future needs.

EU27 not only needs to develop its own form of capitalism to reclaim what financial capitalism has taken away but is also well placed to do so. It can operate from a position of strength and the European Enterprise Model can enforce what is already strong. The National governments, the Commission, the Council and the European Parliament can each take unique and valuable steps to bring this desired future closer.

Lowering corporate tax rates is not the way forward, depreciation of investments upon completion is. Banks can reduce their risks by helping enterprises concentrate on value creation. Pension Funds have long term obligations that are far better served by enterprises that focus on cash flow now and in the future. Regulators should welcome the transparency the European Enterprise can offer.

Donald Kalff, MBA, PhD is a former member of the KLM Executive Board and a (co) founder of six biotech and ICT companies. He has published extensively about corporate governance and its relation to innovation and investment. He is the author of two books on the subject. His latest book, “The European Enterprise” will see the light of day by the end of this year.