CONTINENTAL EUROPEAN VARIETIES OF CAPITALISM

EB434 ENTERPRISE + GOVERNANCE
social democracy

- Historical legacies of war, revolution and class conflict, and organized labor have seen state intervention in markets (labor, capital and product) in postwar Europe

- Social peace has been considered a prerequisite for economic development

- Strong legal protections of employees (with Italian provisions again dismissal, for instance, being the strictest in Europe)
Labour productivity levels in Europe
OECD 2012

GDP by hour worked in US$

- over $55
- $55 - $50
- $50 - $45
- $45 - $40
- below $40
- unavailable

https://upload.wikimedia.org/wikipedia/commons/3/3b/Labour_productivity_levels_in_europe.svg
Protectionist

Employment protection indicator
Permanent workers, 6 = most restrictive

2003  2013

Portugal
Germany
Sweden
Italy
France
Spain
Britain
United States

Source: OECD  *Strictness of dismissal regulations
‘Corporatism’ – especially in Germany – brings national representatives of employer and employee organisations together, with state representatives, to negotiate compensation outcomes (at national or sectoral level).

French and southern European experience is of varied union militancy across sectors.

In Scandinavia organisations above a certain size are required to have consulting mechanisms with employees.

But managers are strategically alert to such constraints and shape organisations & informational flows to minimise operational impacts.
nationalisations

- Left wing governments in Europe often had the state intervene in the market for corporate control – taking over key enterprises

- This often arose in response to the declining financial health of firms with large capital needs that were vulnerable to hold-up by militant employees – eg. railways, airlines, manufacturers deemed to be of strategic economic importance (France & Italy providing key examples)

- Managerial elites in charge of some state enterprises

- Significant privatisations have followed in certain economies, although sometimes with socialisation of losses
valuable firms & brands
but fewer
publicly-listed
European firms

Source: https://cdn.howmuch.net/articles/the-worlds-most-valuable-brands-2019
Europe

Size of bubble
Total capitalization of domestic stock markets and equivalent US-listed company

relative scale of total stock market capitalisations

Quartz | qz.com

Data: World Federation of Exchanges, FactSet
Data as of Feb. 2019, in US dollar terms
Diversification Helps You Capture What Global Markets Offer

Percent of world market capitalization as of December 31, 2013

- 45 countries
- 12,000 publicly traded stocks
- $45.4 trillion market value

The global equity market is large and represents a world of investment opportunity.

In US dollars. Diversification does not eliminate the risk of market loss. Market cap data is free-float adjusted from Bloomberg securities data. Many small nations not displayed. Totals may not equal 100% due to rounding. For educational purposes; should not be used as investment advice.
Pax Americana
The world according to free-float equity market capitalization ($bn)

- US stock market capitalization is $19.8tn (as measured by MSCI).
- The US currently represents 52% of world market capitalization, the highest since the 1980s.
- Next largest markets are Japan, UK, France, Switzerland, Germany, and China.
Figure 7. Market Cap/GDP and GDP/Capita for the World's 53 Largest Economies in 2014

Source: Haver Analytics Citi Research
transparent accounting

• Account-keeping is generally quite sophisticated

• But firms’ financial statements are often not transparent to either outside parties or stakeholders like employees

• Management deliberately avoids open disclosure of the firms’ financial position in a detailed way to avoid further demands from labour and other stakeholders when the firm is doing well

• Large block-holders can gain information on the firm’s financial health privately from management

• Limited disclosure also makes a hostile takeover more risky for the acquirer as can’t value the enterprise or identify rationalisation opportunities from outside easily
incentive compensation

• Large incentive compensation (like USA) is rare in continental Europe

• Despite this, managerial compensation is generally not publicly revealed – for fear of provoking industrial relations and political conflict

• Introduction of incentive stock options has been contentious – eg. when Daimler-Benz did in late 1990s, despite the small size of the option plan

• Left-wing governments have generally opposed incentive compensation (eg. in France explicitly)

• but the elite status of management in firms is often reflected in other ways
France as example

- Had strong securities markets in the 19th century
- French statism was initially conservative and pro-business
- But a militant socialist movement threatened business interests at both the firm level through strike action and the state level through political movements
- Defensive business culture of limited expansion, family block owners, recruitment of managers from within the controlling family took hold
- Post WWII, securities markets did not develop fully
- Little separation of ownership and control
A French model?

- Even conservative French governments, such as under President Giscard intervened to prevent bankruptcies, hostile takeovers, and corporate downsizing

- Employee share ownership has been promoted as a means to reduce takeovers

- French market institutions (stock market, regulators, central bank) do not have the same independence from the government of the day as do those in Anglo-American countries

- A national managerial elite moves between state, state-owned and private (but state supported) agencies and enterprises

- Would-be investors have guarded their interests through block holdings that give them control as counterweight to other stakeholders
German firm types

- Public companies – Aktiengesellschaft – AG
- Private limited liability companies – Gesellschaft mit beschränkter Haftung – GmbH
- Hybrid form which combines advantages of an unincorporated Kommanditgesellschaft and limited liability of the GmbH
- Germany has proportionately far fewer publicly listed companies than in Anglo-American countries
- The German stock market is therefore also generally less developed
- Listed companies also have a large block shareholder, meaning far less full separation of ownership and control
German governance

- Germany is distinguished by heavy state intervention in corporate governance to protect and empower employees
- Industrial relations (employee relations) is a major issue in corporate governance
- Work councils sets employee wages and conditions in consultation between management and union
- Codetermination – right of employees to be kept informed and participate in decisions affecting them
- Codetermination system, formalised in law in 1976, gives 1/3 of seats on the firm’s supervisory board (aufsichtsrat - board of directors) to employees in smaller companies and one half of all seats to larger companies
German dynamics

• Dual board system – in addition to the supervisory board (Aufsichtsrat) is a management board (Vorstand)

• The Vorstand exercises responsibility for day-to-day management of the enterprise and is the focus of the senior management team. It does not have direct employee representation.

• Supervisory board meetings are usually much less common than for Anglo-American boards of directors

• The German board is generally much less well informed, especially in advance, of the firm’s financial performance

• The 2002 Cromme Code specifies that the management board should coordinate with the supervisory report and publish firm’s financial statements on the internet prior to the annual shareholders’ meeting
reaction to co-determination

- Block shareholdings are, at least in part, a reaction to the power of labor in the firm (and political pressures partly were also a reaction to the power of block shareholders)

- Board meetings are fewer, and information sharing less, in order to avoid strengthening labour interests further

- Out-of-boardroom governance – involving direct contact between senior management and key owners – is a significant feature

- These reactions to the power of employees gives some protection to key owners (against managerial agency costs) but gives no protection to minority shareholders

- Minority shareholders are therefore more limited
Italy

- Italian business is characterised by a few large public firms and many small family-owned firms.

- Corporatist experience under Fascist regime from 1920s to 1943 and some subsequent tripartite bargaining between labour, business & state in postwar era.

- Postwar, intense industrial (eg. Fiat case) and political conflicts between left, especially communists, and conservative forces.

- Neither communism or Catholic conservatism had positive views of the role of the market.

- Historically weak institutions of market governance – a securities commission was created only in 1974 and fair trade (anti-trust or competition policy) commission was established in 1990.
Italian insiders

- Public firms are controlled by key block-holders, typically associated with founding families, who control the firm and related businesses through complex ownership pyramids.

- Resources could be shifted from outsiders (minority shareholders) to block owners.

- This has made such equity investments by those outside the control in-group less desirable.

- Weak basic corporate law has been complemented by larger minority investors seeking contract-based protections against controlling in-group malfeasance.

- Competition policy has been weakly enforced, compounding the control of key entrepreneurs.
takeovers in Europe

- Merger and Acquisition activity has become more significant, especially with free product markets in the EU increasing competition and removal of intra-European capital controls
- Yet takeovers have been actively regulated in some European states – especially in France
- While direct state regulatory intervention was more limited in Germany, hostile takeovers have been rare and provoked strong negative reactions from unions, and leading political actors
- Varied regulatory regimes across EU but consultation obligations with employee groups is common
- Netherlands has a compulsory approval process to protect employee interests
challenges

- Greater product market competition & now recession reduces rents available to managers and employees
- Wider acceptance in Europe of potential benefits of Anglo-American style corporate governance
- 1999 OECD corporate governance code reflected that
- Smaller European economies see advantages in attracting investment through leading corporate governance practices
- Gradual recognition of looming retirements incomes crises in Europe and the need to both encourage private investment and better financial returns on those investments
- The European public finance & banking crises are huge constraints & also reminders of the need for such a change
The German, French and other European models (eg. Holland, Denmark etc) that give labour strong legal protection and influence in corporate governance have **disadvantages and advantages**

- Managers’ interests align less with shareholders and more with employees, increasing managerial agency costs
- While large shareholders may protect their interests somewhat through informal governance and direct participation in management, minority shareholders suffer
- Benefits of broader and deeper equities investment markets are foregone – an issuing with aging populations
- BUT higher levels of trust in firms that might lead to higher productivity and long-term growth – especially in Germany
models of capitalism?

• There is intense debate over ‘models of capitalism’ in Europe today

• Distributional issues are addressed in these countries through the welfare system – with enormous burdens on public finance that are worsening and high tax burdens on individuals and firms are a consequence

• Competitive pressures from European integration, East Asia and the Americas, compound debates

• Many European firms increasingly argue that their competitiveness is hampered by their European location, though current Euro weakness helps

• But managers and block holders are protected more