# FINANCE, COMPANIES AND COMPETITION

*Divergences between countries in the industrial competitiveness – especially between France and Germany – are causing economic dislocation in the euro zone and undermining Europe's ability to compete on the international stage. These problems have been compounded by the increasing financialisation of corporate governance and an ideology hostile to industrial policy. Remedying this situation requires a combination of two priorities: multi-stakeholder governance and the development of innovation solutions.*

by Michel Aglietta

**Let us start with the French example. Ever since the Gallois report, there has been no denying the fact that French industrial performance deteriorated significantly in the ten years preceding the crisis.** Rising wages and shrinking margins are common excuses for shortcomings in management accountability. Competitiveness is seen solely as a reflection of payroll costs, which naturally points the finger at the labour market. Industrial policy is content to focus on internal devaluation, resorting to wage deflation, pitching one country against another.

The media overlooks the lack of research and development among companies in southern Europe, France included. Since 2002, R&D in the private sector has never exceeded 1.4% in France, compared with an average of 1.9% in Germany, 2.0% in the United States, 2.5% in Japan, and 2.8% in Sweden. Meanwhile, French companies continue to lose ground in automating industrial production processes: they had bought 3.5 times fewer industrial robots than their German counterparts in 2001; seven times fewer in 2011. Research into total factor productivity (TFP) shows that the particularly dated assets of French companies are a key contributor to the slowdown in productivity. Payroll costs may well be growing in France more than elsewhere, but that is because productivity is stalling.

**Key Points**

- *Shareholder governance is subject to the whims of stock markets and focuses on clearing debts. It encourages offshoring and therefore deindustrialisation.*
- *Protecting market share in a highly competitive environment requires the pursuit of incremental innovation based on the valorisation of intangible assets.*





"IF FRANCE IS LOSING GROUND, THEN IT IS BECAUSE **ITS FIRMS ARE FAILING TO INVEST ENOUGH IN INNOVATION.**"

This offers a new perspective on the issue of competitiveness. If France is losing ground, then it is because its firms are failing to invest enough in innovation, largely because its business leaders and owners refuse to do so or because they cannot do so. In the first case, we need to consider the type of corporate governance cultivated by the financialisation of the economy. In the second, we need to look beyond the capacity of companies to produce technological, human, information and financial resources and assess the kind of innovation systems in which they use them.

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## FINANCIALISATION AND GOVERNANCE

After the Second World War, France pursued modernisation under the impetus and guidance of central government. State patronage allowed French capitalism to build competitiveness clusters in transport, energy, construction materials and chemicals. With the introduction of the Common Market, the industrial model shifted in favour of increased competition, with currency devaluation occasionally used to offset a lack of competitiveness. European constraints changed the rules of the game as financial deregulation began to gather steam. The 1983 watershed for competitive disinflation caused a passive trend toward neoliberalism, which turned active in 1995 when the fabric of capitalistic interests came apart at the seams and the sudden surge of US and UK shareholders in CAC40 companies caused upheaval in corporate governance. French capitalism embraced pro-shareholder governance with open arms, in contrast to the stakeholder view prevailing in Germany. The combination of an overwhelming focus on pushing up share prices and pursuing a hierarchical, pyramid-style approach to business organisation (a long-standing French tradition) strongly discouraged managers from adopting any innovation in productive investment.

Management dependency on company share prices through stock options and the threat of hostile takeovers led by hedge funds and investment banks left business strategies prey to the whims of stock markets. Private equity (PE) provides a capitalistic alternative to flotation. However, PE is particularly harmful to long-term strategies given that more than 70% of a buyout can be financed by debt instead of a real equity contribution. Private equity funds use the assets and future revenues of the companies they target as collateral to secure their loans. Lending banks in turn use asset-backed securities (ABS) to spread risks among investors. Boards of directors are made up of managers from the target company (the ones not laid off) and representatives from the private equity fund. The fund managers seek to squeeze as much profit out of the target company within three to five years to repay their debts and use leverage to secure returns of more than 20%. Such strategies might be compatible with the sudden growth of start-ups. In most cases, however, they represent a form of governance based on stripping and regrouping available assets, destroying rather than creating value to divvy up profits among a financial elite to the detriment of the workforce.

This approach is taken to the extreme in the private-equity model, but it is also widespread in all firms governed by shareholder value. Across 21 European countries, foreign shareholders – including pension funds, private equity firms and hedge funds – held an average of 37% of company shares in 2008, compared with 29% in 2003. This transformation in European shareholding based on the model made popular in the US and UK has led to the disappearance of core shareholders and a loss of majority ownership over time. The stock market has become the only key shareholder, with market value the sole manifestation of shareholder interests. This has had a disastrous impact on methods of governance. Firms are no longer seen as going concerns that require solid backing over time to develop a long-term productive investment strategy. The Wall Street model considers a company to be nothing more than a group of assets that can be sold off separately on the stock market. Liquidity supplants long-term commitment as the primary focus, as investors seek to maximise earnings. The financial crisis has exacerbated this distortion. The drive to shed debt has become the number-one management priority, with massive fluctuations in share prices indicative of price-risk instability, which fetters investment.

Private equity can spur innovation. However, it is a completely different type of private equity that helps small and midsize businesses to pursue new ideas: the type which involves a long-term commitment, which clears debts, which combines venture capital with strategic expertise for fragile yet growing companies. All this requires a wholly different approach to governance.

**MULTI-STAKEHOLDER GOVERNANCE AND EMPLOYEE EMPOWERMENT: THE SOCIAL CONTRACT**

The concept of governance in the interests of shareholders alone stems from an ideological view that gained a following in the United States in the 1970s and became more widespread in the 1980s. This view is based on a mistaken conception of the company that fails to distinguish between the actual business and the "private firm on paper." A company is an undertaking involving a group of people working to produce something that contributes to society. A group of people is not something that can be owned. In contrast, the "private firm on paper" is a corporate body in the shape of a legal entity that determines the purpose of the company. This purpose is capitalist: it follows the abstract reasoning that sees capital in terms of accumulation and therefore the automatic growth in monetary value. In this sense, the private firm owns the company. However, the shareholders simply own part of the firm's assets. They are the rightful owners of the firm as a legal entity, but in no way represent all of its stakeholders.

Those who defend shareholder sovereignty claim that it is warranted because all of the company's other relations are implicitly part of the nexus of contracts and therefore carry prices equivalent to market value. Such claims do not hold water. A company is essentially a team. What makes that team effective is the cooperation and synergy between its members and their skills. As a consequence, a company's share price does not fully reflect its use to society. The conflict of interests between shareholders and the people who make up the company warrants another distribution of power, in the shape of multi-stakeholder governance, and a conduit for that power, in the shape of the board of directors, which is more than simply a mouthpiece for shareholders.

"PAYROLL COSTS MAY WELL BE GROWING IN FRANCE MORE THAN ELSEWHERE, **BUT THAT IS BECAUSE PRODUCTIVITY IS STALLING."**





Stakeholders have a range of interests. The board of directors does not act on behalf of a single party. It sets company policy, and comes to agreement through deliberation. As a result, it has a strategic objective that is reflected in standards of governance. It is the board's role to oversee the company management – or technostructure – to ensure that it complies with standards of governance. Since the corporate body entrusts its representative(s) – the board of directors – with the task of organising the company, then governance – through which the board interacts with all aspects of the business structure – must ensure that stakeholder coordination is not hijacked by the interests of management alone. Multi-stakeholder governance implies the use of checks and balances: separation of powers between the chairman and the CEO; internal audit committees reporting to the board of directors and distinct from management; objective criteria and methods for measuring management performance; agenda under the responsibility of the board chairman.

Because it draws on the creativity of the company's human resources, multi-stakeholder governance is key to competitiveness. Indeed, comparative advantages come from within. Productivity stems largely from collective learning: tacit knowledge obtained by pooling skills in a manner that builds on individual capabilities; informal interaction between employees through horizontal structures; motivation through employee empowerment. Only multi-stakeholder governance in which employees are actively represented on the board can create the system of checks and balances needed to cultivate collective skills as a factor of production. Corporate social responsibility is neither a "touch of soul", nor a cost: it is an intangible asset that can increase overall productivity by increasing the efficiency of the labour factor.

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**"A COMPANY IS AN UNDERTAKING INVOLVING A GROUP OF PEOPLE WORKING TO PRODUCE SOMETHING** THAT CONTRIBUTES TO SOCIETY. A GROUP OF PEOPLE IS NOT SOMETHING THAT CAN BE OWNED."

**COMPETITIVENESS AND INNOVATION SYSTEMS**

Yet there is more to the matter. Competitiveness based on intangible assets considers company stakeholders beyond the legal boundaries of the corporate body. There are no clearly defined ownership rights for intangible assets. Intangible assets are a source of positive externalities between the company, other companies, public entities and the local communities in which companies are based. They create a close bond between industry and services, business strategy and economic policy, resulting in products and solutions that are in tune with social issues: examples include the circular economy, energy transition, urban renovation, health and lifestyles. They are often non-rival and a source of

return that is not immediately appropriable. They must be calculated on the basis of notional value. They improve the efficiency of all production processes and the quality of products. From a company standpoint, intangible assets offset the drop in the marginal productivity of physical capital invested as it grows. This is because intangible assets incorporate knowledge and are not destroyed through use. On the contrary, their marginal productivity grows through use. When companies are organised into networks that internalise externalities resulting from this interplay, they create innovation systems. Making the most of this coordination requires a form of governance that recognises the diversity, capacity for interaction and mobility of human resources. In other words, it requires extended stakeholder governance.

There is no single innovation system that is superior to the rest. Differences stem from the cultural traditions, theories on education and ideologies that shape the ways in which companies are viewed. The venture capital contribution to the innovation system in the United States is well known. This approach makes individualism an influential aspect of the business mindset. Entrepreneurs – often with a background in government research – secure the backing of angel investors, who help them get started on the path to growth in areas of innovation in which there is real symbiosis between entrepreneurs. They maintain momentum with the help of private equity firms, which allows them to avoid the premature burden of debt. Success or failure is settled by the Nasdaq.

**"BECAUSE IT DRAWS ON THE CREATIVITY OF THE COMPANY'S HUMAN RESOURCES,** MULTI-STAKEHOLDER GOVERNANCE IS KEY TO COMPETITIVENESS."

This approach to industrial organisation is a far cry from traditional practices in Asia. In Japan, small and midsize enterprises are an integral part of the value chain for major corporations. SMEs are not seen as subcontractors to be used as a means of outsourcing costs; instead, they are viewed as partners on industrial projects. China's Guanxi capitalism is modelled on a network of connections deeply rooted in Confucian tradition. Extended family relations, trust-based ties forged through mutual assistance and shared ethical standards provide building blocks able to stand the test of time.

### GERMAN MITTELSTAND AND THE ABSENCE OF ANY CLEAR INNOVATION SYSTEM IN FRANCE

The Mittelstand is a benchmark for competitive excellence in Europe. It contrasts sharply with the hazy nature of the French industrial organisation that has followed state withdrawal. The surge in Germany's strength as an exporter since the introduction of the euro contrasts with the slow deindustrialisation seen in France. The way in which leading companies have responded to the tougher competition ushered in by globalisation is instructive. German firms have invested heavily in Eastern Europe to hone the competitive edge of innovation systems based on their home turf. They have made a point of integrating their foreign investments closely into their industrial systems back in the Länder. Meanwhile, under the influence of their US and UK shareholders, French companies have allowed themselves to go adrift, even offshoring their research facilities.

**"THE SELF-SUSTAINING DYNAMIC OF INDUSTRIAL GROWTH IMPLIES AN ORGANISED BALANCE OF POWER BETWEEN PUBLIC AUTHORITIES** AND PRIVATE ACTORS. IT ALSO REQUIRES POLICIES DEDICATED TO INNOVATION SYSTEMS."

The Mittelstand is a sort of self-perpetuating ecosystem that creates a virtuous circle underpinning its ability to weather a storm and stand the test of time. At its core is a continuous improvement in the quality of intangible assets. It enables ongoing innovation by increments, something French commentators like to call *la perfection du banal* ("improving on the ordinary" or "building on the banal"). As a result, it is not a system that makes sudden forays into areas of radical innovation. Instead, the industry-wide incremental approach provides a source of invaluable competitive advantages that can ensure solid market share and secure healthy margins. Sound trading accounts allow Mittelstand firms to use cash as their primary source of investment, enabling businesses to remain for the most part family run. This leaves supervisory boards free to pursue an independent strategy in the long term, meaning they can maintain their razor-thin focus in the quest for incremental innovation and market share.

There are three lessons to be learned from the German experience. First, innovation is usually incremental once you have a solid industrial base. Second, niche domestic markets can lead to highly profitable exports into global markets. Third, it is possible to safeguard a wide array of business activities against competition from emerging countries through a policy of innovation that builds on strengths.

Social innovation is the predominant factor in improving competitiveness, involving government initiatives to retrain workers, with close ties between businesses and schools to promote apprenticeships. Two other points of note, lacking in Germany but prevalent in Scandinavia, include equal career opportunities for men and women, and government aid to provide child care for preschoolers.

The self-sustaining dynamic of industrial growth implies an organised balance of power between public authorities and private stakeholders. It also requires policies dedicated to innovation systems. Industrial strategy must be an integral part of local policy. In France, it falls to the regions to promote a new mindset. They must select companies capable of developing regional competitive advantages, identify promising sectors of industry and pursue pilot initiatives backed by public-private funding. To encourage small and midsize businesses to innovate and export, it might help to introduce a specific status for innovative SMEs with access to attractive financing solutions while ensuring more effective support for SMEs abroad. Lastly, repatriating industry and fostering incremental innovation requires using sustainable development as part of a strategy on both a European and national scale.

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