THE EMERGENCE OF EUROPEAN CAPITALISM

Donald Kalff

Today we will mainly discuss cultural issues, although the main concern of most Europeans is money, not culture. Money makes the world go round. Money is mostly paid by Germany, who is Europe's biggest contributor, and is spent by the EU, seen by many as useless. The "We want our Money Back" country is leaving Europe mainly for that reason.

Every German is putting 50 cents per day into the pot. Every Dutch is putting about 66 cents. That is your and my personal cost for Europe, the equivalent of a baked roll. Where does the money come from? It comes from the economic activity of European companies, which create jobs, pay taxes, and make a profit. So you do not need a degree in economics to understand that we need a well working economy to keep Europe together and thriving.

Donald Kalff is a former member of the KLM Executive Board and a co-founder of six biotech and ICT companies. He has published extensively on corporate governance and its relation to innovation and investment. He is the author of two books on the subject. In 2005 Donald wrote a book titled An UnAmerican Business, the Rise of the New European Enterprise. *In Germany the book was titled:* Europas Wirtschaft wird gewinnen. *The German title is a bit misleading, because someone has to lose if Europe is going to win. But we are just learning that economics at its best is a win-win situation for all participants. In his book, by relying on the data of maybe 2003 and 2004, Donald analyzed the major reasons for the economic crisis in 2000/2001, the famous Dotcom-Bubble, and the Americanization of European economic thinking at that time, which relied on the notion of shareholder value.*

Donald concluded that America was not able or willing to learn from that crisis and he foresaw the next crisis, the subprime-crisis, which hit the globe in 2007. At least to my opinion, no one, especially America, has really learnt from that crisis, so that the next crisis is already looming. It is time to rethink capitalism, by emphasizing the advantages of the European way to do business.

Accordingly, Donald is going to sketch some ideas that can be used to conceive a new European way of capitalism. Eventually, we have two Donalds in the room: Donald Kalff, with his new ideas on capitalism, and, in the background, the other Donald, who is leading America back to the dark ages of capitalism. (Hans-Ulrich Niedner)

Many thanks for the opportunity to share with you my views on the future of capitalism in Europe. This subject is obviously related to the fate of our liberal democracies and the next phase of European integration. It is already a cliché that — until the next French presidential election — we have 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 exploited in economic activity, the rest of it is packaged and re-packaged in products that are traded between banks and other financial institutions.

Financial capitalism is the perverted version of a system that has served extremely well Western Europe since World War II and that, more recently, has brought wealth and stability to Southern and Eastern Europe. Financial capitalism originated in the US and the UK and the liberalization of financial markets in the world paved the way for its expansion. 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 behavior 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 produce very little. Bringing the banks under control after the financial crisis only produced mixed results, at the expense of taxpayers and bank customers.

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

We should capitalize on the fact that financial capitalism is its own worst enemy because it 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. I will talk 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 will reduce pressure to fall in line with 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 oppose financial capitalism.

I am not a macro economist, a political economist, or an economic sociologist. These are fields that have contributed very little to the analysis of the current situation. I believe that a micro economic perspective is required to understand the causes of the malaise and to identify remedies.

I will now take you to a world with which most of you are not familiar. This is 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, build highly efficient worldwide production, and supply chains. They can tackle large scale, technologically advanced, high-risk projects. They set standards that create new kinds of desirable products. They increase the number of talented managers and provide, directly and indirectly, high quality employment.

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

It is therefore understandable that, in the wake of the economic crisis in 2008, central banks and governments, facing a deep recession, accommodated the private sector in general and large enterprises in particular through their policies. Central banks lowered interest rates to the maximum extent possible. Many governments lowered tax rates, made labor 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 the next generations, who must deal with mountains of private and public debt, it delayed the adaptation of Southern European economies 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, they are the best enterprises in the world. How have they performed since the financial crisis of 2008?

Growth of investment has been poor and the returns on past investments have 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 that as it may, the most depressing finding by far is that productivity growth has slowed down, year after year.

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

Something is seriously wrong when enterprises cannot 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. These are advantages that European companies can only dream.

My diagnosis is that financial markets have made value destruction all but inevitable. This also provides an explanation for the decline of productivity that has so far puzzled politicians and economists. Here the role of stock markets is essential as they allow 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, this model offers a very attractive way to do business. However, its key characteristics are fundamentally flawed.

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

Plausible as it 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`, which postulates that the relevant information about a company is reflected in the price of its shares, has been 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 the sacrifices made to improve profit per share will not produce the desired outcome. Capital and talent have been 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 to cut cost, which is synonymous with a reduction of manpower. It is a dark secret that those plans hardly are successful.

Pushing for profits also puts constant pressure on investments. Accounting rules suggest that the early losses caused by investments are at the expense of corporate profits. Accounting rules also lead to prefer acquisitions on investments, 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 the 60% to 80% of the cases.

The concentration on profit per share also explains the frantic buying back shares, lowering the denominator. This testifies to the management's inability to identify value that creates investments.

All of the three popular policies of the Anglo-Saxon Enterprise Model are fueled by the management's remuneration packages, which is largely variable and tied to profit per share or to the share price itself.

The Model's 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 individual leadership is very much in the interest of financial markets. Individuals are highly sensitive to the views prevailing among 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 the removal of a single person is enough, when radical change in the company is required.

Here is the basic flaw in this argument. Over the years, social psychological research has showed the limitations of individuals to process and analyze information and to take decisions on that basis. Such problems are worsened 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 judgement is clouded by an astonishing range of biases and stereotypes; our ability to read human behavior and to convince our fellow man is pretentious. I should also mention problems such as narcissism and other forms of psychopathology, which are quite common among CEOs.

In such a context, the victim is the quality of decision making, with enterprises making commitments that cause the destruction of economic value.

The Model's third key characteristic is the reliance on target setting and the rigid control over each manager and each employee, combined to significant rewards and severe punishments. J&J used to have a policy called "three strikes and you are out", meaning that the third failure was fatal, if you did not meet your target twice. Now, the new policy is "two strikes and you are out". This is the strategy of management by fear. I would 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 given by the belief that internal competition will bring the best out of people. Is anyone surprised by the fact that lack of trust is required for innovation and value creation? Trust should be a basic condition for cooperation.

Summing up, the way enterprises are managed 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 the parties that have a vested interest in the enterprise. This model is the most unfortunate, since it stands for value destruction. Let me just remind you that this was the preferred model for listed European enterprises until the mid-eighties, when it was swept aside by the weak Anglo-Saxon model. Its shortcomings are multiple.

Embracing this model means being open to all comers, legitimate or not. Often, this causes serious distractions. More important is the fact that, in this model, only the current stakeholders are taken into consideration, nobody comes to the rescue of future stakeholders.

Many interests are institutionalized, and power is exercised without accountability and, often, without knowledge of the real cost requested to meet the demands. Established stakeholders defend their positions vigorously, often serving a clientele that strives for short-term success. Often, the management is left to juggle very different viewpoints, expressed by various 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 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 another model and it is good news that European enterprises operating with very different principles are flourishing. It is encouraging that we find such enterprises in numerous economic sectors, that they apply very different technologies, and that they are in various stages of development. For example, Norske Nordic is a fundamentally different company from GSK, so is Statoil from BP and Svenska Handelsbanken from Barclays, and all the three are far more successful than their British competitors.

What they have in common apparently works. I have labeled 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. It is an economic actor that can engage in contractual relationships and that is accountable for its actions. The European Enterprise is not an instrument in the hands of its shareholders and it is not the servant of the special interests of the day. It is an indispensable institution, since it is the only true source of economic growth: indeed, it grants an increase of productivity, driven by the introduction of smarter working methods and by investments.

The European Enterprise strives for the so-called economic profit, which profoundly differs 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, the European Enterprise Model also includes the costs employed by the enterprise to run its business and to make investments. Bank loans need to be repaid, interest payments on the outstanding debt and dividend payments to shareholders need to be made.

All this is basic 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 matters of opinion. They are sometimes subject to arcane accounting principles and they are easy to manipulate by the management. Most importantly, accounting profits are very poor guides for decision-making. For example, enterprises tend to back their most profitable units. Unfortunately, the current profitability is a very poor predictor of future profitability.

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

Focusing on cash also implies a focus on the future, since the value of an enterprise is the sum of all its future annual net cash-flows, corrected for inflation. Focusing on the future helps enterprises to see more opportunities and increases the warning time for unfavorable developments. It forces the enterprises to anticipate the legislation to come and to take "external" costs into account.

Finally, focusing on cash and therefore on the future helps to 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 cash-flows will suffer and their existence will be endangered. Shell and Total felt the pressure to tackle climate change early on, ExxonMobil and Chevron felt that much later.

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

In the European Enterprise Model, leadership is provided by a chairman, who heads a modern day collaborative management team. Only teams can control individual biases and stereotypes. At the same time, the chairman prevents "groupthink".

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

Competence and independence are essential to create trust in the leadership and to grant authority by the rank and file.

Entrepreneurship takes central stage, as the leadership carries responsibility for innovation, for the development of new business models, and for the construction of the organization that supports all of this. The main goal is to bring the enterprise's value creation to a structurally higher level.

Such an organization optimizes the value of the existing business models. First, it does that by minimizing the inevitable erosion of value caused by the daily disturbances, due to mistakes, unexpected events, and bad luck. Second, it achieves that goal by improving performance and exploiting the available expertise and assets. This is the so-called "multi factor productivity", the little understood sum of all the improvements that cannot be attributed to new ICT, plant and equipment.

Moreover, the European Enterprise Model needs to invest in expertise and assets to increase the positive cash-flow. Clearly, when the projected extra revenues are not higher than the extra costs (including the cost of capital) economic value is destroyed.

The results of the European Model are only possible with a far-reaching delegation of responsibilities, whereas the economic value perspective directly links individual performance to the prosperity of the enterprise. The advantages of the European Model are the freedom to operate, a clear "line of sight" between individual contributions and the performance of the enterprise, as well as room for craftsmanship, the desire to produce quality for its own sake, the creation of a strong bond between individuals and the enterprise. I urge you to look at Novo Nordisk, Statoil, and Svenska Han-delsbanken 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 more and more blurred 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. It provides fertile ground for it for the following reasons:

- 75% of the financing of US companies takes place with the stock market as intermediary. In EU27 this happens for only 25% of the companies, as banks still play a major role in corporate finance and banks are cash oriented. This provides 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 unparalleled web of trade agreement;
- Enterprises in EU27 will experience a tailwind as markets for goods services and labor, the largest markets in the world, will further integrate.
- European values such as reasonableness, fairness, and moderation are highly beneficial for modern enterprises that depend on the cooperation among a variety of partners.

Conversely, the European Enterprise Model 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 it is also well prepared 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 take unique and valuable steps to bring this future closer.

Lowering corporate tax rates is not the right way to move forward, instead depreciation of investments upon completion is. Banks can reduce their risks by helping enterprises to 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 that the European Enterprise Model can offer.