Better finance for more enterprise growth in Europe

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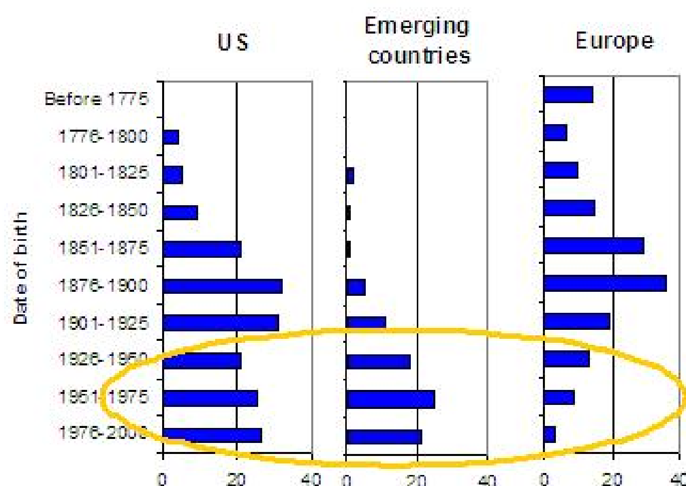
The corporate giants of Europe are aging elders. This column suggests financial reforms to encourage the growth of emerging enterprises.

The recent financial turmoil will certainly lead policy-makers to reconsider existing regulations of financial markets and institutions. It would be misguided to focus exclusively on stability, however. What the European financial system lacks above all is the ability to foster the growth of emerging companies. According to Aghion, Fally and Scarpetta (2007), among others, financial development is particularly important for the entry and expansion of new businesses, possibly more so than labour market flexibility. We take this logic one step further and argue that some types of financial developments are more needed than others at this stage in the economic history of Europe.

The lack of emerging firms in Europe

Entry, exit, and the reallocation of resources among firms play a crucial role in the process of economic growth.[1] Europe's corporate landscape, however, is dominated by old, established companies. A look at the age distribution of the world's 500 largest listed companies shows that European 'champions' are generally much older than American ones, let alone those from emerging markets, as illustrated by Figure 1. Europe's corporate giants include only 12 companies born in the second half of the 20th century, against 51 in the US and 46 in emerging countries.

Figure 1. 'Population Pyramids' of FT Global 500 Listed Companies, 2007



Notes: Horizontal bars show the number of companies in each age category. Source: Nicolas Véron, "Europe's Ageing Corporate Champions", Bruegel Working Paper, forthcoming in 2008. Based on FT Global 500 ranking of the world's largest listed companies, 30 September 2007, published on www.ft.com.

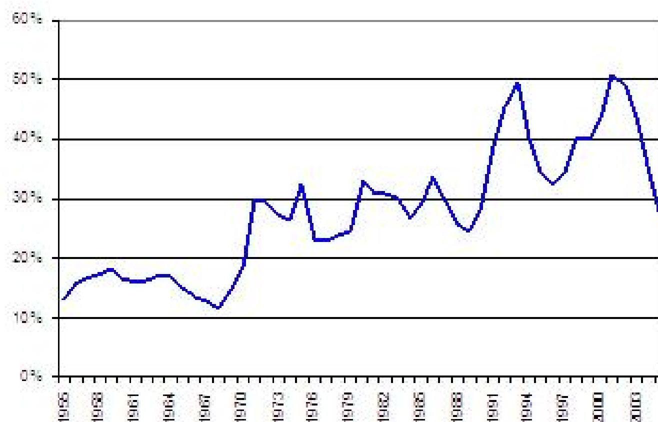
Europe's champions are doing well in the global competition. Their relative weight in the global 'top

500' has slightly increased in the past half-decade, while that of US 'champions' has declined almost continuously as companies from emerging economies have gradually taken their place.[2] Large companies in the United States are not only challenged from abroad but also from within by new entrants, while in Europe the largest companies are more likely to remain for a long time at the top of their industries.
Why is Europe unable to breed new corporate giants the way America does? The dynamic interactions between firms and universities certainly play a role, but one must keep in mind that high-tech companies remain a minority among the new American giants, and that service innovators are just as important. Another reason why American firms grow much faster than European start ups, however, is that the American finance industry offers them more support.

Financing emerging firms

Emerging and established firms have different financial requirements, and Europe provides less financial support to the former than the latter. The continent's large companies can rely on deep, liquid and efficient capital markets. But as far as financing cash-poor firms with limited physical collateral, Europe lags severely behind the United States.
In fact, one can make the case that part of the impressive growth of the US financial sector was driven precisely by the need to finance emerging firms. Figure 2 shows the share of US total investment made by firms whose cash flows cover less than one-third of their capital expenditures. This share has risen over the post-war period, suggesting an increased ability of the financial sector to provide these firms with adequate funding to finance their investments. This contrasts with the 1950s and 1960s, when investment was mostly done by firms with large cash flows and little need for financial intermediation.

Figure 2. Share of Low Cash Firms in Total Investment, 1955-2005



Notes: Adapted from Thomas Philippon, "Why Has The U.S. Financial Sector Grown So Much?", Working paper, NYU-Stern, 2007. The line shows the fraction of total investment done by firms whose cash flows are less than one third of their capital expenditures. Unfortunately, no comparable information is currently available for Europe.

Appropriate financial instruments are particularly crucial for service companies and companies at the high end of manufacturing activities (such as design, research and development, and supply chain management), because their investment is mainly in intangibles that cannot easily be pledged as collateral. Leasing, another popular financing solution, is also inaccessible to firms that do not invest in tangible assets.
The US financial system has evolved quickly to provide these new financial solutions, such as high-yield bonds, mezzanine debt[3], and private equity. All these markets are comparatively less developed in Europe.

How policy can help

To be helpful, policy should focus on the needs of emerging companies. The integration of the European financial markets has already delivered its benefits to large companies. Informational and legal frictions are harder to overcome for smaller firms, but much more can be done in a few key areas.

First, the financial sector must be competitive. Adequately supervised non-banking entities should be allowed to compete with banks on a wide range of services, eliminating current distortions: for example, non-banks are still prohibited from offering leasing or factoring services in Austria, France, Italy and Portugal.

Second, the logic of regulation should be reconsidered. We now have restrictive and complex regulations as benchmarks, with exceptions for small firms. As a result, these small firms need legal advice to understand not only the rules but also the exceptions. This entire logic should be reversed. The benchmark should be simple regulations for everyone, and added obligations for large firms, when needed.

Third, taxes should treat all financial instruments equally. The differential tax treatment of debt and equity, for instance, is not based on any valid economic justifications. It creates loopholes and biases against equity-like investments. In late 2005, the US Advisory Panel on Federal Tax Reform proposed taxing all corporate cash flows with a flat rate, expensing all new investments, and eliminating business interest expense deductions for non-financial firms.[4] Europe should consider such a proposal.

Fourth, insolvency legislation should be improved and harmonised as much as possible. Bankruptcy codes largely determine whether risky debt products are attractive or not. They need to be predictable and inexpensive, and they must allow for the rapid workout of ailing companies with the possibility of quick capital redeployment and fairer compromises between different categories of stakeholders than currently exist in many countries.[5] Moreover, to exploit the returns to scale that Europe can offer, bankruptcy codes should be harmonised.

Finally, the prudential regulations that hamper equity (including private equity) investment by institutional investors such as pension funds and insurance companies should be revised, thus completing the already significant improvements made by many European countries in this area over the past few years.

These five reforms would encourage the expansion of young enterprises and permit the emergence of a new generation of corporate giants. Without them, Europe risks letting the benefits of dynamism pass it by as its old champions continue to dominate.

References

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Footnotes

1 For example, see Foster, Haltiwanger and Krizan (1998) and Bartelsman, Haltiwanger, and Scarpetta (2004). ;

2 Exchange rate fluctuations play a role but do not explain the trend, since much of the decline occurred in 2004-06, a period when the euro/dollar parity was fairly stable at around $1.2-1.3 for one euro.

3 Mezzanine debt typically includes warrants attached (or equity co-investments) to the debt obligation, along with the interest payment associated with debt.

4 www.taxreformpanel.gov.

5 See for instance “Submission on Insolvency Law Reform”, European High Yield Association (EHYA), April 2007.

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