The rise of internal capitalist diversity? Changing patterns of finance and corporate governance in Europe

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Abstract

The article examines internal diversity within national models of capitalism in Europe, with a particular concern with firm financing and corporate governance patterns. It is suggested that a relatively small number of firms have shifted to a new institutional context consisting of common international institutions and practices, while the large majority of firms continue to operate in a more slowly evolving set of domestic institutions or rules. Examining changes since the early 1990s in firm financing and corporate governance, the article finds preliminary evidence to support the thesis of increasing diversity, but also that national patterns of firm finance are still distinct. Rising diversity challenges the long-term viability of coordinated market economies in Europe.

Keywords: SME; finance; corporate governance; varieties of capitalism; financialization.

Introduction

This article pursues the question of whether there has been growing internal diversity within national models of capitalism in Europe, with a particular concern with firm financing patterns and corporate governance. Why does this matter? One compelling answer is rooted in the comparative capitalisms
literature which assumes that the relationship between firms and the financial system is a core institutional dimension that helps constitute the overall logic and comparative institutional advantage of each national economy (Deeg & Jackson, 2007). In this literature, market-dominated (or liberal) political economies are associated with heavy reliance on market finance and, in turn, successful promotion of risk-oriented and innovative firms. Conversely, in more coordinated forms of capitalism, firm finance is much more dependent on banks. This institutional pattern is associated with successful promotion of long-term investment (through ‘patient capital’) and incremental innovation. The problem is that such theories of capitalist variety assume that each nation can be characterized by a representative firm. Yet, if heterogeneity is rising, we must wonder how this affects the overall model and its institutionally-derived competitive advantage. Can coordinated capitalisms be sustained if, for instance, large firms in these economies no longer maintain the long-term relationships that undergirded them because of greater reliance on market finance?

I begin by proposing a conceptual schema for understanding internal diversity in firm finance and corporate governance (Figure 1). The schema starts with two ideal-types of firm financing models. The first embodies the traditional firm which is unlisted, relies on domestic bank financing, has concentrated ownership, makes little effort to comply with shareholder value principles and uses national financial reporting and accounting standards. Firms in this category are largely maintaining their traditional national patterns of finance and, in most cases, relative dependence on banks. This does not mean that this model is static, but rather that the firms in this category continue to operate within the traditional institutional context. The other model I call the ‘international’ firm model. The ideal-typical ‘international’ firm is publicly listed, relies on market finance for external financing, pursues a shareholder value orientation in management and corporate governance, has dispersed ownership and utilizes international financial reporting and accounting standards. The initial presumption, which I seek to validate with the data to follow, is that in all national cases the large majority of firms fall into the traditional national pattern, while only a relatively small number closely approximate the international model. Between these two is a set of hybrid firms. A hybrid firm, for example, may be a large firm that is publicly

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Figure 1 Schematic conception of internal diversity
listed but has concentrated ownership and complies with only some of the international standards and norms on corporate governance.

As we move conceptually from the traditional to the international model, the firm is characterized by a higher degree of financialization. In this article I focus on control financialization which refers to ‘the process by which the maximisation of shareholder value [SV] has become the primary objective of firms’ managers’ (Nölke & Perry, 2007, p. 8). The increased orientation to shareholder value is itself driven by pressures from financial markets and financial investors. With greater financialization both shareholders and managers begin to view the firm as a collection of assets, with the primary criterion for managing each of those assets being maximum profit extraction. To be clear, the degree of financialization is quite variable, both within and across national economies.

As Figure 1 suggests, there are two primary firm characteristics that appear to play a major role in determining a firm’s category: the first characteristic is size, the second is ownership (private versus public listing). These characteristics have long distinguished firms in their financing patterns and thus come as no surprise. Yet this begs the question of whether internal diversity in firm financing is qualitatively different today than in the past. This article will claim that formal changes in the institutions that govern finance and shifting financial markets have together **amplified diversity** within national financial systems since the early 1990s. This amplification is more pronounced in coordinated than in liberal systems of capitalisms (see also Sako, 2007). This is largely because in coordinated systems large firms, while often listed and employing more market finance than small firms, nonetheless conformed to a traditional pattern emphasizing patient capital in the form of concentrated ownership, relationship banking, etc. For such firms, the move towards the international model represents a greater shift in financial and corporate governance practices than for firms operating within traditionally liberal market economies. Thus rising diversity appears to be part of an internally uneven process of liberalization, i.e. financialization.

What are the factors driving internal diversity in finance? The answer must begin with a more general argument about what is causing financial system change. This is obviously a broad topic with an abundant interdisciplinary literature, but for our purposes we can return to the process of financialization. Simplifying the argument, financialization began with the removal of capital controls and early moves to deregulate financial markets in the US and Europe in the 1970s but especially 1980s. To a considerable degree, financialization became a self-reinforcing process as market actors used new freedoms to expand financial markets and create new financial product markets. As markets expanded, new financial actors such as institutional investors, hedge and private equity funds emerged that further reinforce financialization. In the European context, the efforts of the European Union to foster market integration have obviously played a major role in promoting financial system and corporate governance changes.
Analysing the deeper causes of financialization *per se*, however, goes beyond the scope of this article. The pertinent question is: why does it affect firms to different degrees, both within and across national contexts? The answer to this question starts with the relationship between institutions and actor behaviour. In much of the comparative capitalisms literature, especially the varieties of capitalism variant (Hall & Soskice, 2001), institutions are viewed as highly determinative of how firms construct their capacities in the finance, training, production and so on necessary for success. On this basis it becomes possible to construct national models of capitalism in which practically all firms are seen as conforming to an ideal-type favoured by the national institutional context. More recent contributions to this literature, in contrast, stress that institutions are not so deterministic; rather they constrain the range of choice and the resources needed to pursue ‘alternative’ organizational forms and strategies not supported by the institutional environment (see Deeg & Jackson, 2007). Among other things, this view acknowledges that some internal diversity has always existed within national models. Rising internal diversity is thus rooted in the declining restrictiveness or constraints imposed by domestic institutional environments. This is attributable to two factors: the first is that new institutions have been introduced into national contexts that either do not apply to all firms or do not affect all equally, and the second is that large and small firms have different capacities and preferences regarding how – or whether – they use the expanded set of market options and formal institutions available to them.

In regard to new institutions, one crucial set of changes is found in stock exchange regulation, financial reporting and corporate governance regulations where the requirements and rules for financial transparency placed on firms that are listed have grown vividly, thus widening the gap between listed and unlisted firms. Listed firms that utilize market finance are also exposed to higher pressure from markets and financial actors to maximize financial returns and conform to international practices and norms in financial management practices, accounting, etc. (see also Aoki, Jackson & Miyajima, 2007). Unlisted firms generally do not face these pressures, or certainly not to the same degree. Institutional change has also taken the form of ‘layering’ in which new institutions create new but optional strategies for firms (Streeck & Thelen, 2005). Layering is often undertaken when resistance to wholesale institutional change cannot be overcome. Thus many of the financial market and especially corporate governance reforms undertaken relied on voluntary compliance or expanded the menu of choices, thus actually creating more room for firms to make divergent choices. This kind of reform was typically a political compromise between firms resistant to financialization and those that embrace it. Italy is a particularly good example of this (Culpepper, 2007; Deeg, 2005). This also explains why some firms are hybrids of the traditional and international models.

Thus formal institutional change has opened the door for greater diversity in firm choices and how they utilize institutions to create new capacities for
action (Crouch, 2005). Some firms have embraced the international model, while others seek to limit financial market pressures by various means such as retaining concentrated ownership, especially by families. Control by blockholding owners (or in some cases incumbent managers) is often enhanced through a variety of mechanisms – such as pyramids – that political leaders have discouraged but have not had the clout to eliminate. Diversity among smaller firms is rooted partly in divergent preferences among them and partly in well-known technical and economic barriers to their participation in the ‘international’ model. For many modes of market finance they are simply too small to utilize them economically (e.g. bonds or even private equity). Mediated financing, whether by banks or other financial institutions, remains the most cost-effective. That said, there is considerable variation across national contexts in the degree to which SMEs utilize non-bank finance such as public or private equity and the explanation for this lies at least partly in historically-rooted national institutions and complementarities among them (see Deeg & Jackson, 2007). For example, since 2005 all listed European firms are required to use International Accounting Standards and Financial Reporting Standards. When the Commission attempted in 2007 to extend the same requirements to non-listed firms, it elicited a groundswell of opposition that began with German SMEs who feared it would undermine their traditional reliance on bank borrowing in which owner capital plays a crucial role as collateral. The revolt soon spilled over into the European parliament and the Commission backed off (Nölke & Perry, 2007). This example also highlights the fact that EU efforts at integration have focused on larger and listed firms since they are more likely to engage in market-integrating activities.

The next two sections provide empirical evidence on changing patterns of firm finance and corporate governance, first for large firms and then for SMEs. The final section turns to a discussion of the consequences of rising internal diversity for national political economies.

The changing context of large firms in Europe

In this section I examine five general features hypothesized to be constitutive of the international firm model. First, firms are no longer restricted (by either regulation or market structures) in their financing options to domestic financial institutions and make increasing use of foreign or international markets; second, there is a general shift in firm financing patterns from bank to market and self-finance; third, firms in this system are increasingly subject to a common set of rules of financial transparency and financial practices; fourth, firms in this system are subject to increasingly common corporate governance rules and practices, such as shareholder value, minority shareholder protection, etc.; and, fifth, firm strategies and restructuring are increasingly subject to influence outside firm management or corporate
insiders, especially by financial market actors (notably institutional investors, hedge and equity funds), which leads to a more active market for corporate control and restructuring via takeovers, mergers and acquisitions. To be clear, the claim here is one of limited convergence, as there is still considerable diversity across and within nations. I attempt to provide data that covers most or all of the EU-15, but focus on developments in the four largest European economies: Germany, UK, France and Italy.

**Growth of international finance**

That large firms increasingly utilize international or foreign markets for finance is uncontroversial and well documented. Figure 2 shows outstanding international corporate debt as a percentage of GDP. The data show relatively stable levels of debt from 1993 to 1997 followed by a marked rise in all cases from 1997 on, with a slight drop after 2003 reflecting the global economic slowdown. The most dramatic increase is in France, which now has more outstanding international corporate debt than the UK. The shift from domestic to international financing is further validated in Figure 3, which shows that from 1989 to 2005 outstanding domestic corporate debt declined in Germany and France, while rising only marginally in the UK and Italy. International corporate debt is primarily in the form of bonds or other tradable securities which are overwhelmingly the realm of large firms.

**Changing patterns of firm finance: shift to market and self-finance**

At the aggregate level, for more than thirty years there has been a broad trend toward increasing self-finance and market finance by European corporations, and this has been most pronounced among larger firms: Galizia’s (2003) study

![Figure 2](image_url)  
*Figure 2* Outstanding international corporate debt as a percentage of GDP  
*Source:* Data on debt from BIS; GDP data from IMF.
shows the percentage of total capital formation self-financed by French firms rising from about 65 per cent in the 1970s to more than 95 per cent in the 1990s; for German firms this number rose from about 72 per cent to 86 per cent; for Italian firms from 38 per cent to 73 per cent; and UK firms from about 87 per cent to 97 per cent. Figures 4 and 5 confirm a continuation of this general trend during the early 2000s and validate a shift from loan to marketable securities (notably bonds) financing in this period (see also Murinda, Agung & Mullineux, 2004).

While these data support the conclusion of a trend away from bank financing by firms (Byrne & Davis, 2002), especially larger ones, banks are still the single most important source of external finance in most European countries. Moreover, cyclical effects can easily mask long-term trends, and the picture varies widely from country to country. In Germany, for instance, the evidence suggests that there has been no clear long-term structural shift in the

Figure 3 Outstanding domestic corporate debt as a percentage of GDP
Source: Data on debt from BIS; GDP data from IMF.

Figure 4 Percentage of loans in total liabilities: non-financial corporations
Source: Eurostat.
aggregate for firms’ external financing from loans to securities (Figure 4; Schmidt, Hackethal & Tyrell, 2001; Vitols, 2004, p. 20). When broken down by firm size, however, the picture is different: large firms have always relied much less on bank and external debt than smaller firms, and this divergence has grown over time (Hackethal, Schmidt & Tyrell, 2005, p. 9; Rivaud-Danset & Oheix, 2005; Rivaud-Danset, Dubocage & Salais, 1998; Schmidt et al., 2001). For France, on the other hand, there is considerable evidence indicating a significant structural shift away from bank financing for firms (Figure 4) and towards the use of securities markets (Figure 5; O’Sullivan, 2007), and this pattern applies across all size categories, although more for large than small firms (Culpepper, 2005; Schmidt et al., 2001). But perhaps the most striking change in France is the overall rise in self-financing by firms which has brought the French pattern of firm financing (bank borrowing, self-finance and shareholder equity) much closer to that of the UK (also Byrne & Davis, 2002).

Common rules and norms of financial management

In both direct and indirect ways, numerous market and regulatory developments in Europe since the early 1990s have considerably increased the external transparency of the financial practices and condition of large firms in Europe. First, beginning in 2005, the EU required all listed firms (approximately 7,000) in member states to begin publishing consolidated financial statements in accordance with International Financial Reporting Standards and International Accounting Standards (IAS). The shift within IAS from historic book to fair-value accounting adds further pressure on managers to focus more on financial profitability (Nölke & Perry, 2007). Second, increased transparency and common financial disclosure rules were furthered by regulatory changes and listing rules in European stock exchanges during the 1990s. The consolidation of exchanges within Europe and across the Atlantic means that publicly-traded firms now face a similar set of disclosure rules regardless of
where they are listed. Third, and only recently beginning to receive attention, is the growing influence of bond-rating agencies on corporate financial practices. Any firm that issues bonds or other debt securities is likely to be rated by at least one of three major bond-rating agencies which apply their standards and norms commonly across all markets. Moreover, the new Basel capital adequacy standards incorporate debt ratings for assessing capital reserve ratios for financial institutions, thus making ratings even more important to firms and lenders. All three major ratings agencies are American in origin and tend to spread Anglo-American norms about financial practices, corporate governance and ultimately management practices (Sinclair, 2005).

Altogether, common accounting standards, stock listing regulations and ratings agencies make corporate balance sheets more directly comparable across national settings. Among other things, this facilitates the ability of international investors to compare corporate performance across borders and to apply pressure on firm management. In sum, large European firms are part of an emerging, common global orthodoxy about financial practices and transparency (and the knock-on implications for general management practices). These rules generally do not apply to firms which do not issue market-traded debt or list their equity on public exchanges.

Corporate governance norms and rules

By the early 2000s most European countries had by and large completed a wave of corporate governance reform. Despite considerable variation in the actual impact on firm behaviour, the number of common rules and laws adopted is considerable (not least because of EU Directives in this area). We can identify some major common changes in rules, practices and norms.

First, shareholder value, as a set of norms and practices, has come to be the umbrella concept deployed both in public discourse and management practices to reflect the broad sweep of corporate governance changes. For shareholder value advocates, a central path to its achievement is through enhanced minority shareholder protection, such as rules that prevent or eliminate unequal voting and control rights and strengthened disclosure and transparency rules (Culpepper, 2005; Gourevitch & Shinn, 2005). Most nations have also made efforts to strengthen boards of directors or supervisory boards to oversee and control managers in the interests of shareholders. Finally, we can point to an increased use of performance-related pay for managers as a common corporate governance trend. The objective of these measures is to make the interests of shareholders and managers coincide by linking managers’ remuneration with the performance of the firm through performance-related forms of compensation such as stock options.

Whether corporate governance reforms led to convergence among corporate governance systems in Europe is still debated (Goyer, 2006; Gourevitch & Shinn, 2005; O’Sullivan, 2003). Reflecting this, and notwithstanding the
common trends just discussed, there is considerable diversity in reform efforts and outcomes. First, corporate governance reforms have so far had relatively little consequence for the vast majority of small and medium-sized firms in most countries, since such firms are not typically listed and the EU has made little effort to change corporate governance rules for SMEs. Even among large firms, many are relatively unaffected because they have some degree of choice in the extent to which they change their corporate governance practices, often because countries adopted voluntary corporate governance codes rather than a full regime of mandatory corporate governance rules. In practice it is enterprises that are more globally-oriented or whose shares are widely held which have generally made the most changes, i.e. come closest to the ‘international model’ (e.g. Börsch, 2007; Höpner, 2001). Second, firms in different national political economies have chosen diverse ways to satisfy the corporate governance demands of institutional investors. In France, for example, large firms tend to divest themselves of weaker divisions or subsidiaries in order to increase shareholder value, while in Germany firms commonly appease investors by increasing the transparency of management and company finances (Börsch, 2007; Goyer, 2006). In Germany corporate reforms also left intact key elements of its traditional corporate governance model such as co-determination and works councils which are typically viewed as antithetical to shareholder value (Jackson, 2005; Vitols, 2004).

Enterprise ownership, control and restructuring

Distinctions among capitalist systems in general and corporate governance models in particular have been determined to a significant degree based on patterns in the ownership of enterprises. In this regard, scholars typically distinguish between concentrated ownership, in which block-holders (insiders) play a dominant role, and diffuse ownership, in which portfolio shareholders (outsiders) dominate (Franks & Mayer, 1990). For much of the postwar period, large firms in Europe, especially on the continent, were controlled by large block-holders (often including the state). The control of insiders was also frequently strengthened through a variety of control-enhancing mechanisms (CEMs) such as dual voting shares, cross-shareholdings, pyramids, etc. With the growth of securities markets, rise of institutional investors and corporate governance reforms, a key question is whether ownership patterns have changed and whether ownership rights are increasingly aligned with control rights.

In some traditionally insider-oriented systems there has been a significant decline in the extent to which particular firms are controlled by block-holders. First, extensive privatization in much of Europe led to a major retreat in the importance of the state as a block-holder, and many state shares ended up in the hands of minority shareholders. In the largest French listed companies, networks of cross-shareholding, which were put in place in the wake of their
privatizations, unravelled in the late 1990s, leading to a surge in foreign ownership (Culpepper, 2005). Indeed, across Europe there is a notable trend towards the unwinding of cross-shareholdings, most strikingly in the cases of France and Germany (European Commission, 2007c). A decline in the role of banks as industrial shareholders is apparent in Germany and non-financial enterprises have also displayed a reduced interest in holding shares in other companies (Beyer & Höpner, 2003). In fact, over the last decade several governments, e.g. Germany and Italy, have actively encouraged – with mixed success – the reduction of block-holding and unwinding of equity links among their large firms in the belief that this would engender a more dynamic corporate sector (Deeg, 2005). At an aggregate level, available evidence indicates ownership concentration is trending down in much of Europe, albeit at a slow pace in most instances. However, what is striking about the continental countries is how robust concentrated ownership and block-holding have proved once we look beyond the top thirty or forty listed companies.

Aside from a broad decline in the prevalence of cross-shareholdings, the use of CEMs to maintain insider control in European corporations does not yet appear to be undergoing a broad-based systematic decline. But the types and extent of such CEMs vary widely from country to country, and across the EU recently listed companies used fewer CEMs than the top-twenty listed firms in their respective nations (European Commission, 2007c). This suggests the beginning of a common trend away from the use of CEMs. Even where CEMs persist, it is clear that their existence has become much more transparent to outsiders. This is crucial because it means that outside investors can make an informed decision about whether to buy a firm’s shares or not – and adjust the price they are willing to pay (European Commission, 2007c).

To summarize, then, there has been a broad trend – or at least concerted efforts with mixed success – to reduce the disproportion between ownership and control that was widespread in postwar Europe. Together with a significant dispersion of ownership in several large firms, since the early 1990s we can identify a growing influence of outside investors over many large firms. The recently rapid growth of hedge and private equity funds that are taking large stakes in, or buying outright, firms in Europe and then restructuring them pushes this financialization process even further. A recent study found convergence across the UK, France and Germany since the early 1990s in the overall rate of mergers and acquisitions activity, suggesting that it now plays a functionally equivalent role in corporate restructuring for all three economies by creating active markets for corporate control (Jackson & Miyajima, 2007).

**The evolving world of SMEs**

In this section I review evidence on changing patterns of SME finance. It begins with a cross-national European comparison followed by discussion of
specific trends and evidence in France, Italy, Germany and the UK. I attempt to provide two basic kinds of data: (1) how much external finance SMEs use and how this changes over time; and (2) what forms and sources of external finance they use. The evidence should be seen as preliminary but it points to an evolution of SME finance at a relatively modest pace. New forms of finance have grown yet traditional patterns and practices remain dominant; most notably, banks continue to be the dominant providers of external finance to SMEs.

**General overview of patterns of SME finance in Europe**

While a complete picture is difficult to construct, available evidence suggests that overall no structural decline in the use of external finance by European SMEs can be deduced. A study by Rivaud-Danset and Oheix (2005), covering a large sample of manufacturing firms in seven European countries from 1991 to 2001, shows no clear decline in the ratio of long-term bank debt for firms of any size. There is a tendency towards less use of short-term bank debt, particularly in Italy and Spain, indicating that their traditionally high use of overdraft borrowing is declining. Table 1 provides summary data from the 2005 Eurobarometer survey. About half of firms in the EU15 utilized bank overdraft facilities, and overdrafts are significant for SMEs in all four cases of concern in this study. Bank loans were also significant for SMEs, though with substantial variation; Italian and British firms use banks less than French or German (though Italian firms have traditionally relied heavily on bank overdrafts for short-term financing).

While bank debts are still the most important source of external finance for SMEs, two other sources of financing that have been available and utilized by SMEs for quite some time have nonetheless become more important for European SMEs in the last ten to fifteen years; namely leasing and factoring (European Commission, 2003). In the 1980s these forms of finance were more typically used by firms facing financial difficulties, but by the late 1990s these forms were used largely to finance fixed assets and higher working capital demands, respectively (European Commission, 2003).

While systematic, Europe-wide data are not available, country-specific studies and other evidence suggest that leasing is utilized most heavily by SMEs (European Commission, 2003, p. 31). In comparison, factoring is utilized by fewer firms but in France, the UK and Italy is notably significant. Across the EU, 91 per cent of factoring company clients are SMEs with turnover of less than €15 million (European Commission, 2003), and the survey indicates about 20 per cent of SMEs utilize it. Measured by percentage of GDP, factoring is most important in Italy (7.56 per cent), followed by the UK (6.96 per cent), France (3.35 per cent) and Germany (1.04 per cent). Finally, trade credit has long been a significant source of short-term financing for SMEs (and more so than for large firms) across Europe.
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(notably in France and Italy), and, given the indicators of declining short-term bank finance, is likely to remain significant (European Commission, 2003, p. 29).13

Public bond issues are out of the question for virtually all SMEs, since the minimum issue is generally regarded to be well beyond their reach at €100 million (European Commission, 2001). SMEs could, however, benefit indirectly from the growth of bond markets via the securitization of banks’ SME loan portfolios which would enable banks to reduce risks and thus provide more loans at lower cost. However, this market segment has developed much more slowly than the general asset-backed securities market in Europe and remains rather small, constituting only 3 per cent of the market by volume (2006); it is estimated that only 1–2 per cent of securitizable SME loans have been securitized. Efforts by public authorities in Germany and Spain to foster SME loan securitization have had some noteworthy effect, and these countries together provided about two-thirds of all securitized SME loans by value in the EU (European Commission, 2007b, pp. 12–13).

SMEs and external equity

During the 1990s there was a widespread push by governments and the especially the Commission (Posner, 2005) to create a new culture of going public for SMEs. Figure 6 demonstrates the burst of Initial Public Offering (IPO) activity in the late 1990s associated with the creation of new stock markets for SMEs. After peaking sometime between 1998 and 2000, the drop off in IPOs is quite dramatic. With the exception of the UK, the IPO market does not revive in Europe until 2005 and remains at levels comparable to the early 1990s. The failure to create a new SME equity culture in continental Europe can also be seen in the total number of listed firms as shown in Figure 7 (also European Commission, 2006). From their 1999 or 2000 peaks, the total number of listed firms drops steadily for Euronext,14 Deutsche Börse and the London main market. The Italian exchange shows a fairly steady increase over the past decade, but the increase is modest and gradual. The striking exception is the increase of market listings in London in the SME-oriented Alternative Investment Market. The explanation for this pattern lies at least in part in extant institutional complementarities: in the UK domestic institutional investors willing to invest in IPOs are comparatively large in terms of the domestic assets they hold, while on the continent the inverse is generally the case (Vitols, 2004). On the firm side, in many countries such as Germany and Italy strong local banking systems ensure adequate capital on competitive terms, thus reducing the attractiveness of an IPO.

The flat IPO market in Europe may also be due in part to the rise of private equity. Private equity funds for SMEs have been present in Europe since well before the 1990s, but outside the UK the number of investments made and total funds invested were quite modest. Moreover, little of this money was
venture capital in the sense of targeting start-up firms or small, innovative and fast-growing firms: in the mid-1990s, venture capital invested in early-stage financing represented less than 0.01 per cent of GDP for the EU-15 (Figure 8). This grew dramatically in most of Europe in the late 1990s but dropped dramatically in all cases after the tech bubble burst. The amount of equity dedicated to early-stage financing in Europe levelled off between 2001 and 2005 at around €10 billion per annum, while equity dedicated to buyout and replacement grew strongly (European Venture Capital Association, 2007). However, 2006 brought a substantial increase in funds raised and invested—some 50 per cent over the prior year—by private equity firms in both

Figure 6 IPOs by domestic firms only
Notes: Includes regulated and unregulated markets; investment firms excluded; France data becomes Euronext from 2001–6.

Figure 7 Number of listed companies (all segments)
Notes: Deutsche Börse excludes unregulated segment (Freiverkehr); London all segments from World Federation of Exchanges.
Figure 8 Venture capital investments by type of investment stage as a percentage of GDP: early stage investments

Sources: European Venture Capital Association; PricewaterhouseCoopers.
replacement and venture capital. Of the some €70 billion invested in 2006, 74 per cent of the amount was invested in buyouts (average buyout investment was about €27 million). Of the some 7,500 investments made in 2006, 76 per cent were for venture capital and 90 per cent of investment deals were in firms with less than 500 employees (European Venture Capital Association, 2007). Even so, private equity firms are generally interested only in larger mid-sized firms because of the high fixed costs for due diligence and firm evaluations (Lange & Becker-Ritterspach, 2007). While a private equity investment eliminates many of the requirements placed on firms by a public listing and may shield firm managers from short-term financial market pressures, private equity investors typically apply high profit expectations to firms and plan on selling their participation within a fixed period. In this sense equity firm participation can be viewed as a form of financialization of the firm.

Behind this general picture lies substantial national variation. The UK remains the leader for private equity funds invested and number of deals, with nearly three times the investment value ($29.6 billion) of the next highest European country, France ($9.1 billion in 2005); Germany lags considerably behind and, until 2006, private equity in Italy had fallen back to negligible levels (Figure 8; International Financial Services 2006b). In the past decade or so mezzanine finance – hybrids of debt and equity such as participating loans or convertible bonds – has also become a noteworthy form of finance. However, this market has been strongest for larger and higher-rated SMEs, thus the percentage of SMEs using mezzanine finance is very small and is expected to remain so (European Commission, 2007a).

The survey in Table 1 suggests that, on average, 14 per cent of SMEs in Europe utilize various forms of public or publicly-backed finance. Though I do not present data in this article, given the EU’s efforts to curb government subsidies in general, the value of publicly-subsidized finance for SMEs has probably not grown substantially in the past twenty years, though the types of programmes promoted appear to have shifted towards those that utilize public funds to leverage more private equity/venture capital investments or to promote securitization of SME loans (European Commission, 2006).

The general picture presented by this overview could be summarized thus: today, as in the past, SMEs largely self-finance their investment. In some countries SMEs are more leveraged than large firms, but in others there is no substantial difference. Banks continue to remain the most important source of external funds for SMEs, though their importance is generally trending downward, especially as they are providing less short-term financing. That said, while bank lending may be declining in favour of other forms of finance such as leasing or factoring, many of the suppliers of these alternative sources are bank subsidiaries. On the demand side, many SMEs are finding alternative sources of funds, or are taking advantage of lower and steadier interest rates to replace some short-term funds with long-term borrowing. There has been a significant increase in the number of SMEs utilizing new forms of external equity, though this is occurring through private rather than public investment.
These trends are significantly more pronounced in some countries than others. That said, the percentage of SMEs utilizing new forms of equity finance remains very small, and the number (and value) of continental SMEs utilizing venture capital, private equity, mezzanine finance, etc., remains far behind the percentages found in the UK and US.

**Country-specific patterns: France, Germany, Italy and the UK**

**United Kingdom**  UK firms have generally lower levels of external debt than their continental counterparts and a higher portion of SMEs with no external debt at all (Burns, 1992). Surveys suggest that, since the late 1980s, SMEs have significantly reduced their reliance on external finance. When they borrowed, they traditionally relied heavily on bank overdrafts and short-term loans (Burns, 1992; Table 1), but since the early 1990s they have increased use of fixed-term loans (Murphy, Young & Jackson, 2004). Criticized by numerous government commissions in the late 1990s for offering SME loans on uncompetitive terms, a more recent report noted that competition among UK banks for SME business has increased, thus improving SME access to loans and bank-firm relations in general (Murphy et al., 2004). Leasing and factoring have also grown substantially since the early 1990s, particularly to replace bank overdrafts (Murphy et al., 2004, p. 16). These forms of finance are often taken from bank subsidiaries (Murphy et al., 2004, p. 20). That said, UK firms make significantly greater use of non-bank finance companies than SMEs in the rest of Europe (EOS Gallup Europe, 2005).

Perhaps the single most important distinguishing characteristic of SMEs in the UK is their comparatively greater use of external equity finance. From the early 1990s to early 2000s, there was significant growth in the amount of private equity funds invested in UK firms, though the total number of investments remained roughly constant at around 1200 per annum. The percentage going into venture capital (early stage) remains rather low at 4 per cent, which compares to 5 per cent for Europe as a whole (International Financial Services, 2006b). In short, UK firms account for a disproportionate share of Europe’s private equity volume – one-third of total European investment in 2006 – but the proportion of UK SMEs receiving private equity appears relatively steady over the longer term. Cumulatively, from 1995 to 2005, UK private equity firms invested some 75 billion in more than 22,000 firms in the UK (International Financial Services, 2006b). Since 2003 there has also been a boom in IPO activity by UK firms, reaching levels much higher than during the 2000 boom (Figure 5). This is clearly attributable to the success of the Alternative Investment Market established in 1998.

**France**  Contrary to the expectations of many, SME finance in France has become more similar to that of the UK. In the 1970s and 80s, French firms (of
all sizes) used external debt to finance investment at rates considerably higher than in the UK and even bank-dominated Germany; over the 1980s and 1990s, this figure plunged to an even lower level than in the UK – meaning that more than 95 per cent of investment was financed internally (Galizia, 2003; also Byrne & Davis 2002). The decline in external finance occurs across all size categories of firms in France. Commensurate with this, equity ratios of French firms more than doubled from the mid-1980s to the late 1990s, reaching about 33 per cent of liabilities (and this level was the same across all sizes of firms).20

Given the greater decline in bank borrowing by large firms, the proportion of business loans made by French banks going to SMEs increased significantly during the 1990s (from 35 per cent in 1993 to 43 per cent in 2000).21 As elsewhere in Europe, SMEs draw a higher proportion of their financial debt from bank loans than do large firms (81–5 per cent versus 59 per cent for large firms). Thus, as in the UK, French SMEs are in aggregate borrowing less from banks while simultaneously enjoying increased attention from banks to their financing needs. As in Italy, French firms rely comparatively more on trade credit than SMEs in other European countries (European Commission, 2003, p. 29). Leasing and especially factoring (about 30 per cent of firms are estimated to use this) are also significant sources of external finance (Burns, 1992; European Commission, 2003, p. 32; Table 1).

When it comes to using external private equity, French firms are notably more open than their counterparts in nearly all other continental countries. From 1997 to 2006, private equity investment rose at an annual rate of 26 per cent, reaching €10.2 billion (Banque de France, 2007, p. 116). In 2005 private equity investment reached 0.4 per cent of GDP – the same level as in the United States (though well below the UK’s leading 1.3 per cent and Sweden’s 1 per cent) (International Financial Services, 2006b). However, as in many other cases, the dramatic growth in French private equity was in buyouts, which tend to be larger firms, rather than start-ups and early-stage financing which benefits small firms.22 Unlike the UK and more in keeping with continental Europe, French firms are not turning to public equity markets via IPOs (Figure 6).

**Italy** About 30 per cent of SMEs have no bank debt, and this figure rises to nearly 50 per cent of firms with fewer than thirty employees (Guiso, 2003, p. 125). Trade debt is generally as, or more, important than other forms of financial debt (Guiso, 2003; European Commission, 2003, p. 29). Leasing and factoring also appear to be relatively important in Italy compared with other European countries (Table 1). To the extent that SMEs use external financing, it comes overwhelmingly from banks (on average 95 per cent of external financial debt), though largely in the form of overdrafts rather than long-term loans (Guiso, 2003; Table 1). In short, Italian SMEs have tended towards relatively low external finance (with an inverse relationship between firm size and debt ratio) and much of what they do borrow is on a short-term basis.
(Guiso, 2003, p. 125; also Burns, 1992). From the late 1990s through to the early 2000s Italian SMEs reduced the number of banking connections they have while increasing the amount of borrowing from their principal bank (Capitalia, 2005, p. 48). With the decrease in inflation and stable interest rates beginning in the 1990s, there has also been a trend to replace short- with long-term debt, though short-term debt still represents 70–80 per cent of debt for SMEs (and 60–70 per cent for large Italian firms) (Capitalia, 2005, p. 60). Together these facts suggest that SMEs are actually developing closer long-term relations to banks.

While there was a significant increase in the late 1990s in private equity, Italy lagged well behind other European countries in both absolute amounts and relative to GDP (Figure 8). That said, the private equity market came alive in 2006 with €4.9 billion invested, putting Italy ahead of Germany in terms of percentage of GDP (European Venture Capital Association, 2007).

Germany

Germany has long been seen as the paragon of a bank-based financial system and the picture for SMEs generally bears this out. First, among our four cases, Germany has historically had the highest level of bank loans as a percentage of company liabilities. Bank debt as a percentage of balance sheet totals has remained steady for German SMEs since the mid-1990s (Hommel & Schneider, 2003, p. 84), though there is widespread belief in Germany that Basel II regulations are leading to stricter lending conditions. Compared to our other cases, bank borrowing by German SMEs has also been composed to a much greater degree of long-term debts, as opposed to short-term and overdrafts (Rivaud-Danset et al., 1998, pp. 32–3; also Burns 1992; Hommel & Schneider, 2003, pp. 62–3; Table 1). Trade credits, and especially leasing, have become important alternative sources of external funds, but bank borrowing still dominates (Hommel & Schneider, 2003, p. 72.). Thus the historic Hausbank relationship appears largely intact for German SMEs.

The low equity ratios of German SMEs compared with large firms and SMEs in other countries suggests that German SMEs are relatively under-capitalized (European Commission, 2003, p. 21; Rivaud-Danset et al., 1998, p. 31). This ratio has been declining for a long time (Hommel & Schneider, 2003, p. 60), thus precipitating efforts in the 1980s and 1990s by public authorities to expand publicly financed equity funds and stimulate the growth of private equity (Deeg, 2005). Following the general European pattern, venture capital (early-stage) did grow dramatically in the late 1990s (Figure 8), but declined equally dramatically after the peak and IPOs ground to a standstill until a modest revival in 2006. Similarly, after 2001 private equity as a whole grew dramatically in Germany, making it the third largest market in Europe (European Venture Capital Association, 2007). Nevertheless, on a GDP basis it remains well behind the UK, France, the Netherlands and Sweden. While this reluctance is often ascribed to the aversion of German SME owners to external control (Hommel & Schneider, 2003), the need for
external equity may also not be as large as it appears. German SMEs have several alternative sources of funds that serve as quasi-equity, such as pension reserves (Rivaud-Danset et al., 1998, pp. 33–4), owners’ private wealth and loans from shareholders (Hommel & Schneider, 2003, pp. 61–2, 72).

Consequences of rising diversity

This article has provided some preliminary evidence for rising diversity in firm financing patterns and corporate governance. It was suggested at the outset that in Europe we find firms falling into three patterns: the large majority of firms, typically unlisted SMEs, continue to operate within evolving traditional national patterns. The data suggest there is not a single European model of SME finance; that is to say, national patterns continue to be distinct. At the other end, a small number of firms, generally large, listed firms, are increasingly operating within an ‘international’ model, or new ‘rules of the game’, that are largely common, international institutions, practices and norms, even if they do not amount to complete convergence. In between these two types we find a number of firms that combine elements of the two models, thus constituting a hybrid pattern. To be sure, the patterns or models described here are schematic and no attempt was made in this article to quantify the number of firms falling into each category.25

The final question we take up here is: how might this apparent growing internal diversity affect national models of capitalism? In the comparative capitalisms literature it is posited that essential complementarities exist between the financial system and other key institutional domains of the economy and together these institutions yield distinct systems of capitalism. In coordinated market economies, long-term finance (‘patient capital’) – notably relational banking practices and concentrated ownership – is hypothesized to support production strategies based on long-term relations, long-term investment and incremental innovation or asset-specific investment (Hall & Soskice, 2001). The leading German firms, for example, have long followed a product market strategy emphasizing the maintenance of technological leadership, thus using technical criteria as much as financial criteria as a basis for investment decisions (Börsch, 2007). Similarly, traditional accounting rules enabled firms to amass large hidden reserves that helped managers smooth out fluctuations in earnings and thus facilitate long-term investment in both labour skills and projects. In the classic ‘Rhenish model’ the purpose of accounting was not to judge firm performance but to assure the bankers there was enough collateral to keep them lending. The required use of International Accounting and Financial Reporting Standards, with their emphasis on fair value accounting principles, reveals such reserves and thus gives financial markets more information to demand that firms put each corporate asset to its most profitable use as judged by financial benchmarks (Nölke & Perry, 2007). The varieties of capitalism school predicts that national capitalisms which mix
institutions with different logics – such as short-term market finance with relatively inflexible labour markets – will under-perform relative to economies whose institutions uniformly follow either a market coordination or a strategic coordination logic. In short, financialization implies less patient capital, thus raising the question of whether this process – to the extent it has occurred – might adversely affect coordinated systems (Lange & Becker-Ritterspach, 2007).

The answer to this question is much debated. On one side, some scholars argue that changes in finance and corporate governance are not fundamentally altering the coordinated character of many CMEs. In this view, CMEs are seen as a bundle of evolving institutional practices that adapt to changes over time. The changes associated with financialization require adjustments by firms, but these have been made in ways that preserve basic patterns of strategic coordination among firms (Börsch, 2007; Hall & Thelen, 2006). Thus the increased shareholder value orientation of large German firms, for example, has not undermined coordination between management and labour (codetermination) because new complementarities have been formed (Höpner, 2005). The relative success of the German economy in recent years suggests that many firms may be successfully combining market finance with traditional German institutions. But, if this is the case, it raises questions as to whether ‘patient capital’ was ever an essential element of CMEs or which aspects of patient capital were – and perhaps still are – essential to CMEs. Some evidence suggests that relational banking may matter less to sustaining strategic coordination than having a stable, long-term concentrated ownership focused on long-term investment.

In contrast, there is the view that the consequences of financialization are still working their way through CMEs. Institutional complementarities between different institutional realms of the economy mean the shorter-term market logic advanced by financialization is slowly spreading (Lane, 2005). Thus while co-determination remains formally intact, its character has shifted to ‘co-management’ in which labour has largely subsumed its goals to those of the corporation (Jackson, 2005). Moreover, in recent years there has been substantial political pressure to reform German co-determination in the direction of less labour representation. In this light, the rise of private equity and hedge fund investors may also be seen as a mechanism for spreading financialization in CMEs beyond large, listed firms. If such investors apply strict cost-cutting and profit maximization standards while loading the firm with debt in order to fund the acquisition, then firms in CMEs may be more likely to disengage from the strategic coordination regimes which are essential to CME’s advantage in incremental innovation. While there is anecdotal evidence to support this erosion hypothesis, there is also evidence that the institutional context of CMEs often modifies the behaviour of such investors (Lange & Becker-Ritterspach, 2007). At this point in time, resolving this debate requires much more empirical research.
The financial crisis of 2008 is likely to have substantial impact on financialization processes. Profit financialization will surely decline significantly, at least for the short to medium term, while financial institutions recover from the crisis and develop new business models. Eventually a new trend line will be established, but it is impossible to forecast what this will look like. The future for control financialization is also unclear; however, there are reasons to believe that this trend will suffer only a temporary setback. First, the leveraged buyout business (the domain of hedge and equity funds) is always cyclical and will eventually return. Second, the institutional investors that are the key drivers of control financialization are likely to maintain, if not increase, their relative importance in financial systems.

Beyond the empirical question about the impact of financialization and rising diversity on firm and national performance lie questions about the conceptual and analytical utility of comparative capitalisms theories. While acknowledging that there has always been internal diversity, these approaches have typically assumed that there is a single national model and that the national level is the most useful level of comparative institutional analysis. But rising internal diversity challenges this premise. In Japan, for example, considerable evidence shows that three models of capitalism have emerged: first is the traditional Japanese model incorporating relational finance and relationship-based cooperation between labour and management and between firms. Alongside this two hybrid forms have emerged. One combines market-based finance with a greater relational orientation in employment relations, the other combines relational financing with more market-oriented employment relations (Aoki and Jackson, 2008; Sako, 2007). The evidence in this article suggests similar internal hybrids may be forming in many European cases. Altogether these indicate that the important institutional complementarities may not operate at the national level so much as at the sectoral and firm level, and that institutional complementarities are more elusive, variable and less constraining on the strategic choices of economic actors (firms) than has been generally assumed (Deeg &Jackson, 2007). But, regardless of the level at which institutional complementarities matter most, if complementarities do indeed impact on firm and national performance as a wide variety of theories suggest, growing internal diversity in finance and corporate governance – which constitutes new combinations of institutions – can be expected to impact on performance: the open and empirical question is whether, or under which conditions, this diversity will impact on performance positively or negatively.

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Notes

1 An early version of this paper with more empirical data can be found on the Social Science Research Network (abstract: 1013331).
2 ‘International’ firm in my sense is not based on where it derives its sales, which may be entirely within a single domestic market.
3 Rivaud-Danset and Oheix (2005), for example, studied European manufacturing firms over the 1990s and found a common trend towards less short-term but not long-term bank debt.
4 A non-trivial number of SMEs are also seeking external ratings in order to secure loans at better rates; however, with modifications to the new Basel Capital Adequacy rules, most banks are expected to use internal rating methods to assess the creditworthiness of SMEs.
5 On Italy, see Mengoli, Pazzaglia and Sapienza (2007); on Germany see Vitols (2004); on France see Culpepper (2005).
6 In recent years Germany, Belgium, Estonia, Greece, Luxembourg, Spain and Poland have all moved to strengthen the ‘one-share, one-vote’ principle, though they still allow some CEMs (European Commission, 2007c).
7 The Transparency Directive (2004/109/EC) should lead to a harmonization of rules governing disclosure of CEMs.
8 Hedge funds assets under management in Europe stood at $325 billion at the end of 2005 (compared to $715 billion in US); this represented an increase from $84 billion in 2002 (International Financial Services, 2006a). Equity funds have also grown dramatically; these numbers are discussed in the third section.
9 The seven include Austria, Belgium, France, Germany, Italy, Spain and Sweden.
10 An earlier study by Burns (1992) showed that leasing, as a percentage of total SME debt, had the following percentages: UK (10 per cent), France (19 per cent), Germany (11 per cent), Spain (16 per cent) and Italy (6 per cent).
11 Klapper (2005) also shows substantial growth of factoring in Europe, with factoring turnover growing by 20–40 per cent over the three years from 2000 to 2003 in most EU15 countries: in Germany the three-year growth rate was nearly 50 per cent (though from a low base) and in Spain nearly 100 per cent.
12 These figures represent average annual percentage during the 1994–2003 period. The average for all high-income countries in the study was 2.56 per cent of GDP; ten of the EU–15 countries are above average (Klapper, 2005, p. 33).
13 Though, because they also extend so much trade credit, SMEs are actually net providers of trade credit (Wagenvoort, 2003).
14 Euronext, created in 2001, includes the exchanges of France, Belgium, the Netherlands and Portugal.
15 The Commission estimates that 18 per cent of SMEs in Europe benefit from some kind of financial support (European Commission, 2003, p. 39). In a study by Burns (1992) for the early 1990s, the significance of subsidized loans in total SME debt ranged from 1 per cent in France to 15 per cent in Italy; UK (3 per cent), Spain (5 per cent) and Germany (8 per cent).
16 Indeed, UK firms of all sizes have long relied much less on external finance than European counterparts (Galizia, 2003).
17 In the late 1980s about two-thirds of firms sought external finance and in the early 2000s this number stood around 40 per cent (Murphy et al., 2004, p. 36).
18 At the end of 2003, invoice financing or factoring provided just under £1 billion, while bank overdrafts amounted to just over £9 billion (Murphy et al., 2004, p. 16).

19 The next largest investment recipient in 2006 was France, accounting for 15 per cent of invested private equity, followed by Germany with 10 per cent, the Netherlands with 8 per cent, Italy with 7 per cent, Sweden with 6 per cent and Spain with 5 per cent (European Venture Capital Association, 2006).

20 Dietsch (2003, p. 96). These figures are based on manufacturing firms only.

21 Ibid.

22 In 2006, 80 per cent of investment volume was for buyouts (average investment €22.3 million for 362 firms) and only 16 per cent for start-ups, early stage and expansion financing (average investment €2 million for 816 firms) (Banque de France, 2007, pp. 115–16; author’s own calculations). As a percentage of invested volume, start-up and early-stage financing declined from 22 per cent in 2000 to 5 per cent in 2006.

23 Eurostat data suggest that a comparatively small percentage of this was start-up or venture capital.

24 German SMEs typically have two to four bank connections (Hommel & Schneider, 2003, p. 64).

25 Though this could be done, as Aoki et al. (2007) did for Japan.

References


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