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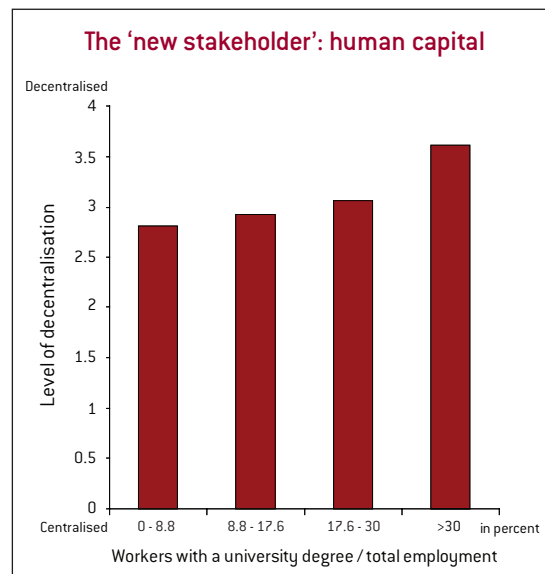
## THE NEW CORPORATION IN EUROPE

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**SUMMARY** Faced with increasing European and global competition and scarcity of top talent, Europe’s corporations are changing the way they do business. Detailed company-level evidence from Germany and Austria show how international firms are slicing up the value chain and introducing flatter chains of command in order to cut costs and woo the high-skill workers vital to them in a knowledge economy. This transformation to the ‘new corporation’ has important implications for the EU as it seeks to re-frame policy for a globalised economy.

### POLICY CHALLENGE

European businesses need to tackle the challenges of European and global competition and the scramble for brains. EU policy can either help or hinder this adaptation. Contrary to popular belief, both offshoring to the near-abroad and immigration of skilled workers can foster European competitiveness and help keep jobs in Europe. The chief challenges for



the EU are threefold: to step up European Neighbourhood Policy as a catalyst for faster and deeper integration of Europe as an economic region; to encourage the mobility of skilled workers; and to make sure that EU trade policy, and especially EU trade defence action, does not score a European ‘own goal’ by obstructing the operation of global value chains where these clearly benefit the European economy as a whole.

Source: Author’s calculations. Figures relate to Germany.



**IN THE LAST 15 YEARS** global trade and investment have undergone dramatic change as a result of opening markets and increased global competition. There is much empirical evidence to show that international trade is growing mainly through an increase in trade in input goods, and in particular through a rise in intra-firm trade – international ‘slicing up’ of the value chain within multinational corporations. According to one estimate, trade in input goods has accounted for a third of the increase in global trade since 1970 (Hummels *et al*, 1998) and global investment outflows increased more than fourfold between 1990 and 2005, from US\$ 202 billion to US\$ 916 billion (World Investment Report 2006, UNCTAD). Within the EU27, intra-firm imports currently range from one quarter to two thirds of total imports between old and new EU member states, smaller countries having a higher volume of intra-firm trade than larger ones<sup>1</sup>.

A second key change in the way international corporations are organised is the trend towards flatter hierarchies – devolving control and management down the corporate chain of command. This delegation of decision-making power, from top management in the parent company to middle management, is driven to a significant extent by a need to attract and retain high-skill workers in an environment of tougher global competition for talent<sup>2</sup>.

The question that then arises is whether there is evidence that the two big changes in corporate configuration described above are linked; in other words whether

firms confronting increased international competition and a battle for talent are renewing themselves both in terms of physical structure and chain of command.

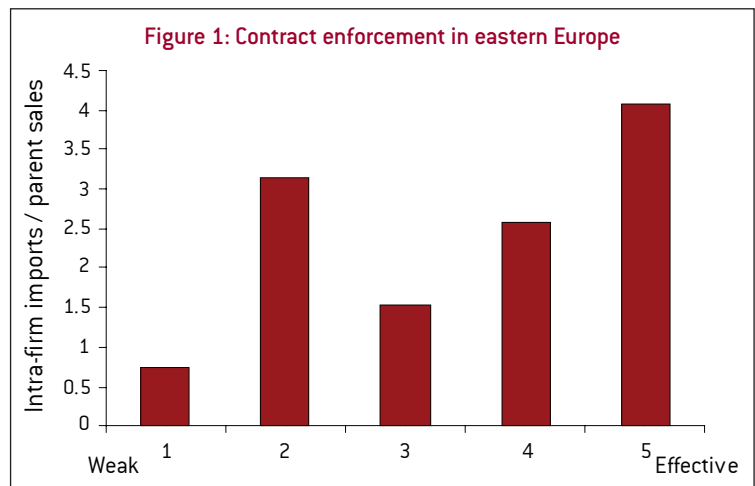
Why does it matter how firms are organised? It matters for several reasons. Recent research suggests (Bloom and Van Reenen, 2007) that, apart from bringing the obvious cost savings, organisational factors and competitive edge are correlated in various ways. Firms with ‘better’ organisation tend, for example, to introduce new information technologies faster and tend to perform better in terms of productivity, market share and profits. The difference in organisational capital between United States and European firms might explain in part why Europe has been trailing the US recently in productivity growth.

This Policy Brief examines the rise of the ‘new corporation’ in Europe. It uses firm-level data from Germany and Austria to document offshoring to eastern Europe and to illustrate how increases in international competition have triggered a change in the way businesses are organised. It

explores how firms have switched to more decentralised, less hierarchical decision-making, and have empowered their high-skill workers in order to retain talent within the firm. Finally, the Policy Brief draws conclusions from the findings and examines the challenges these organisational changes pose for policymakers, in particular in the areas of EU neighbourhood and trade policies.

### 1. THE NEW CORPORATION

With the fall of communism and the opening of markets to eastern Europe in 1989 European firms were able to expand into new markets as well as to find new sources of supply of lower-cost labour and inputs. With the surge in liberalisation both at the European as well as at the international level in the last 15 years, Europe has also considerably increased its openness (from 42 percent to 61 percent, see Box). The resulting increase in competitive pressure both from eastern Europe and the rest of the world has been a driving force behind the search for more efficient modes of organisation. Furthermore, tougher international competition has made it more



Source: Author's calculations.

<sup>1</sup> For a theory of the international organisation of production see Pol Antras and Elhanan Helpman (2004), for global sourcing strategies of European firms see Dalia Marin (2006), for the ‘new new theories’ of international trade, see Elhanan Helpman, Dalia Marin, Thierry Verdier (2008).

<sup>2</sup> For corporate reorganisation of European firms, see Dalia Marin and Thierry Verdier (2008).



important for firms to create new ideas in order to stay competitive, and to hire the talent needed to do this. Improvements in contract enforcement in the former communist countries (Figure 1) made it possible for European firms to use

this region for their sourcing strategies for inputs and talent.

As a result, many firms offshored production to low-wage eastern Europe both to cut costs and to take advantage of the pool of

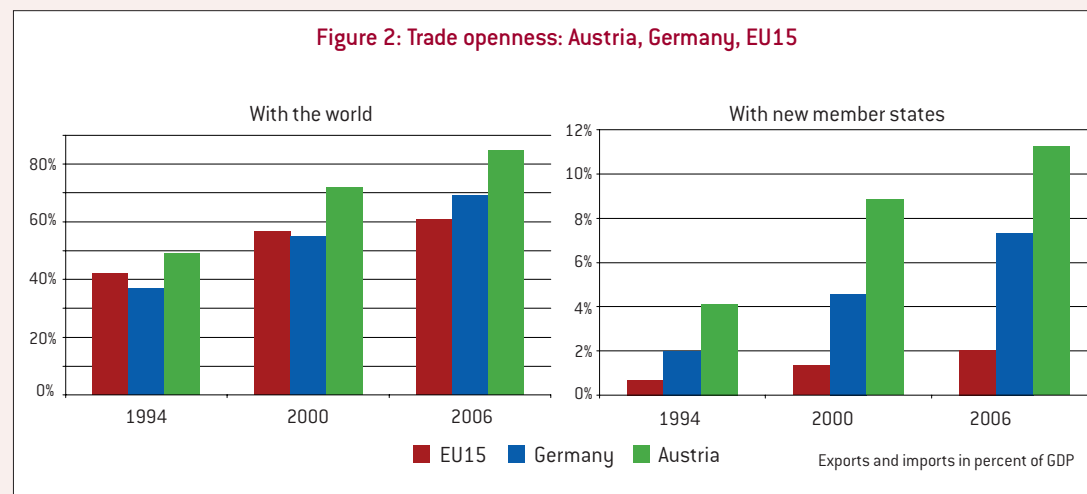
skilled workers available there. Many firms also decentralised decision-making to the divisional level of the corporation to empower middle managers to bring new ideas to the firm and made human capital the 'new

### THE DATA: WHY AUSTRIA AND GERMANY?

Changes in corporate organisation among European firms are documented with detailed firm-level data on 660 global corporations based in Austria (200 firms) and in Germany (460 firms). The sample consists of 2,200 German and Austrian investment projects in eastern Europe over the period 1990 to 2001. In terms of value, the sample of German investments represents 80 percent of German outward foreign investment to eastern Europe and the sample of Austrian investments represents 100 percent of Austrian outward foreign investment to eastern Europe.

Why look at Austrian and German corporations? Austria and Germany are particularly suitable countries to examine how increases in the exposure to international trade and the opening of markets to eastern Europe are driving corporate transformation of European firms. Austria and Germany are among the European countries that are most integrated into the world economy, their openness (exports plus imports as a percentage of GDP in 2006) is 85 and 69 percent respectively, compared to 61 percent for Europe (EU15) as a whole. Moreover, in the last 15 years, these two countries have been among those where the pace of integration into the global economy has been swiftest. In Germany the openness ratio increased from 37 percent in 1994 to 69 percent in 2006, while Austria's trade share increased from 49 percent to 85 percent in the same period. At the same time, Germany and Austria are frontier test cases for the new industrial organisation in Europe. As direct neighbours of eastern Europe, firms in these two countries have been most affected by the opening up to the former communist countries. Exports and imports to the new member states as a percentage of GDP increased from two percent to 7.4 percent in Germany and from 4.1 percent to 11.3 percent in Austria between 1994 and 2006. Furthermore, in 2000-2001, eastern Europe, Russia and Ukraine accounted for 88 percent of Austrian foreign direct investment. German investment-led integration with eastern Europe started later but nevertheless accounted for 20 percent of German foreign direct investment in 2003-2005. Hence, the data and findings for Germany and Austria may give us a useful perspective on patterns that are valid for European firms as a whole.

Figure 2: Trade openness: Austria, Germany, EU15



Source: Thomson Datastream.



stakeholder' in the firm in order to prevent talent from leaving.

### 2. THE INTERNATIONAL ORGANISATION OF PRODUCTION

But how prevalent is offshoring to eastern Europe?

One way to answer this question is to look at intra-firm trade – international trade that takes place within multinational corporations with subsidiaries in eastern Europe. Table 1 shows estimates of the share of intra-firm imports in total imports from eastern Europe between 1997 and 2000 for the corporations sampled. Intra-firm trade with eastern Europe is a dominant phenomenon in Austria's trade: 68.5 percent of Austria's imports from eastern Europe are made up of goods from Austrian subsidiaries. For Germany, intra-firm trade represents a sizeable 21.6 percent of imports from eastern Europe. Indeed, goods from German subsidiaries in Slovakia and Hungary account, respectively, for a hefty 65 percent and 40 percent of German imports from these countries. In sum, the pattern of intra-firm trade that has emerged between some of the older EU member states and eastern Europe clearly suggests that offshoring has become a significant phenomenon for European firms.

### 3. YOUNGER FIRMS, FLATTER HIERARCHIES

How are global trade and competition affecting the internal organisation of European firms?

Corporate transformation to younger organisations and more

	Austria	Germany
Baltic States	0	14.41
Czech Republic	42.17	15.64
Hungary	100	40.46
Poland	64.91	15.34
Slovakia	54.71	64.98
Slovenia	48.36	9.38
Bulgaria	11.32	4.2
Romania	57.46	7.17
Croatia	40.4	1.95
Russia	26.7	1.67
Ukraine	21.52	2.44
Eastern Europe	68.52	21.56

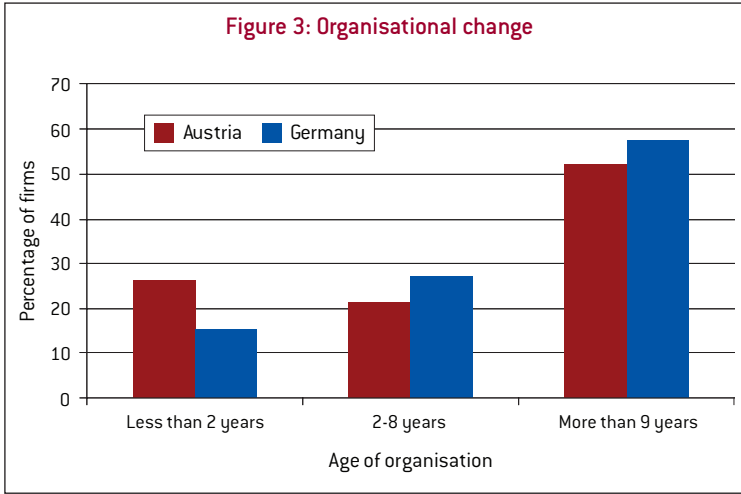
Source: Author's calculations.

decentralised hierarchies among Austrian and German firms are documented in Figures 3 and 4. First, we observe that almost half of all German and Austrian firms in the survey have organisational units which are new or relatively new – under eight years of age. Second, almost two thirds of Austrian firms and over three quarters of German firms have partially or wholly decentralised decision-making. These data tend to support the argument that international firms, faced with increased international competition and the battle for talent, are renewing themselves both in terms of physical structure and chain of command.

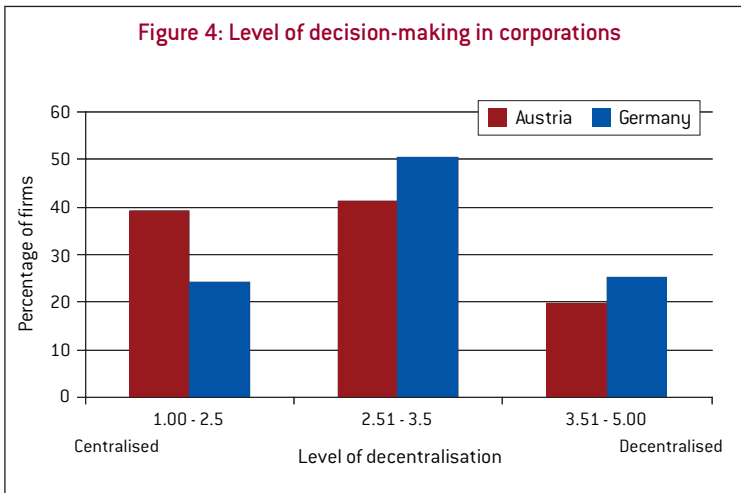
How is international trade influencing the decision where in the corporation to locate decision-making power? This decision is

governed by the trade-off between top-down control and individual initiative within the firm: lack of empowerment leads to the disaffection of middle managers, and delegation of power to middle managers involves the loss of central control. But corporate organisational choices about the optimum level at which to pitch decision-making power are influenced by the degree of exposure of the firm to international competition. With increased foreign competition it matters more for profits who runs the firm – there is more at stake if errors are made. However, at the same time, with increased foreign competition, it also becomes more important to generate new ideas and to empower middle managers to do this. Thus power is decentralised, but when it really comes to the crunch and international

*'Offshoring to eastern Europe has become a significant phenomenon for European firms.'*



Perhaps the most dramatic change observed in the last 15 years – and corroborated by the data in this survey – is that the nature of the corporation itself is changing. Human capital has become the ‘new stakeholder’ in the firm. The enterprise of the past was defined by the ownership of physical assets. Ownership of physical capital was the primary source of power in the enterprise. In contrast, in many enterprises today human capital and talent rather than plant and machinery are the critical assets. Innovative and customised solutions are the key source of profits. Thus, the enterprise’s workforce has become an important source of value to the firm. At the same time, however, due to increased openness human capital and talent have more opportunities than before for professional mobility. Thus, a key focus of corporate governance today is how firms can woo and keep talent<sup>4</sup>.

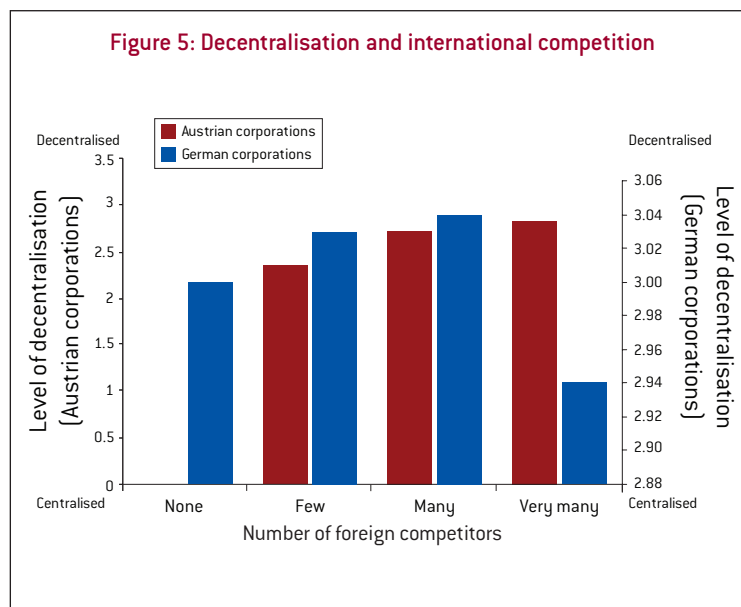


Evidence for this trend is to be found in Figure 6, overleaf, which

Source for Figures 3 and 4: Author’s calculations.

competition becomes very tough, it seems from the evidence that firms ‘play safe’ and re-centralise power<sup>3</sup>.

Figure 5 illustrates the above relationship between the number of foreign competitors and the level of decision-making in corporations in Austria and Germany. Firms are ranked by their level of decentralisation of decision-making for 16 corporate decisions, where 1 represents a decision taken by the CEO at the top of the organisation (centralised firm) and 5 a decision taken at the divisional level (decentralised firm).



Source: Author’s calculations.

<sup>3</sup> See Dalia Marin and Thierry Verdier (2008).

<sup>4</sup> How international trade contributes to the emergence of the ‘talent firm’ in which human capital becomes the ‘new stakeholder’, see Marin and Verdier (2004).



shows that more skill-intensive corporations in Germany – corporations with a larger share of workers with a university education – tend to have more decentralised corporate hierarchies with power delegated to the divisional level.

#### 4. CONCLUSIONS AND POLICY CHALLENGE

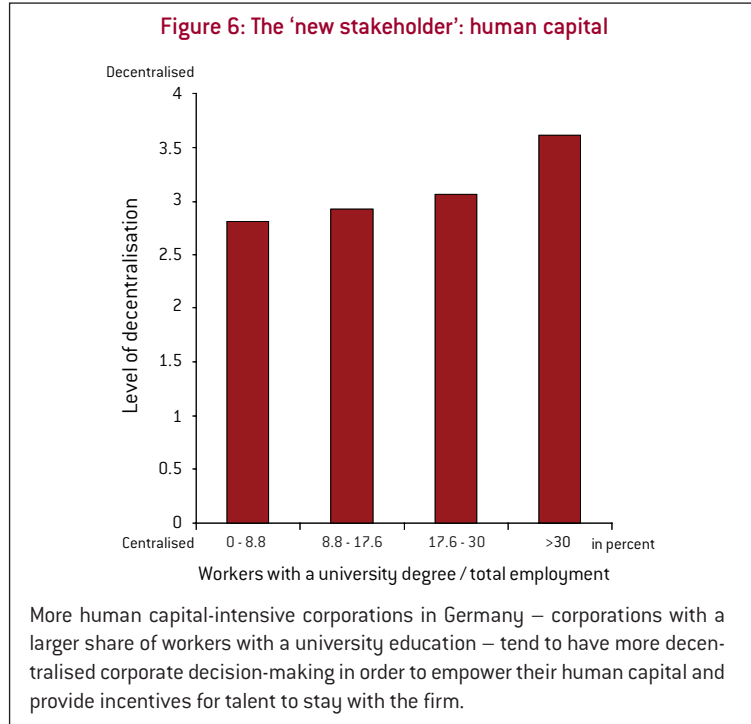
We may draw two general conclusions from the evidence and analysis in this Policy Brief:

The integration of the newer member states of the EU into the European economy is contributing to keeping firms – and thus added value – in Europe at a time of heightening global competition, when firms might otherwise be tempted to move some or all of their operations to China or to other fast-emerging economies.

Flatter corporate hierarchies will tend to help European firms woo and keep high-skill workers against the backdrop of the global battle for talent. And where talent is located, research and development activities are more likely to be situated, again with positive spillovers for added value in Europe.

In light of the above general conclusions, we might draw two more specific policy conclusions:

**EU Neighbourhood Policy:** The EU should step up efforts to integrate the economies of neighbourhood countries into the European economy<sup>5</sup>. The EU should increase efforts to encourage mobility of high-skilled workers in Europe, in particular from the new member states, to help Europe to stay competitive in an increasingly



Source: Author's calculations.

challenging global environment. Firms are doing their part by reorganising their chain of command to empower their human capital workers. Now policy must play its part to facilitate the flow of workers across Europe, in particular from the new member states. Furthermore, the EU should pursue efforts to promote contract enforcement throughout Europe in order to facilitate European business there, which is a key determinant of future economic integration of neighbourhood countries with the EU, to the benefit of both.

**EU Trade Policy:** Where firms need to offshore lower value-added operations outside the EU and its vicinity in order to compete globally, EU policy should not

artificially hinder this process through use of trade defence instruments (antidumping, anti-subsidy action). With the international organisation of production the conflict of interest with respect to the design of trade policy is no longer across sectors as before, but rather takes place within sectors at the firm level and depends on how firms are organised (input-importing firms versus import-competing firms) or takes place within groups (tasks undertaken by workers which are easily transferable to other countries versus tasks not easily transferable). Hence, firm boundaries may become more important than country boundaries for the design of future EU trade policy.

*'Integration of the newer member states into the EU economy contributes to keeping firms in Europe at a time of heightening global competition.'*

<sup>5</sup> See *Fragmented Power: Europe and the Global Economy*, A. Sapir (Ed), Bruegel Books, 2007.



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