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Policy Paper

Unlocking Europe's Piggy Bank

Corporate Saving, Labor Power and Policies for Investment

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#Investment
#Productivity
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European companies invest too little. Instead, firms increasingly retain profits and build up large savings which contributes to low growth, rising inequality and financial instability. Boosting private investment, therefore, has become main priority for the new Commission. Based on new empirical evidence this policy paper proposes a novel strategy to achieve this goal: strengthening the bargaining position of labor.

Table of Contents

1 Introduction

Across Europe, companies invest too little.[1] More than a decade after the last financial crisis, average investment rates of European firms have still not recovered to pre-crisis levels and, in some large member states, they remain well below their historic average (see Figure 1). This lack of private investment has not only dampened economic growth and employment in the European Union. It is also a main reason for the yawning gap between productivity growth and capital formation in Europe and in other major economies such as the US and China.[2] Boosting private investment has, thus, turned into a major priority for the new European Commission for both economic and geopolitical reasons.[3]

The lack of private investment is especially surprising given that European companies are awash with money. However, many profitable firms seem increasingly reluctant to use their revenues to pay higher wages, distribute dividends or invest. Consequently, Europe, in recent years, has witnessed a staggering trend towards rising corporate saving. More and more firms retain substantial proportions of their profits and park them in liquid financial assets and bank accounts.[4] A key question for the new Commission is, therefore, how to persuade European companies to put their cash to work.

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So far, the Commission mainly seeks to achieve this goal either by mobilizing private investment through public funding, for example, with the InvestEU program or by encouraging structural reforms in member states. This policy paper proposes a new strategy to bring down savings and stimulate investment: strengthening the bargaining position of labor. Analyzing data from a large number of advanced economies over the last 20 years, it shows that the rise in corporate saving has been especially pronounced in countries in which the influence of labor unions has declined. Moreover, exploiting a discontinuity provided by the German law on co-determination for a more causal analysis reveals a similar pattern at the firm-level. Granting workers legal authority in firms' decision-making reduces savings. Contrary to what one might expect, this does not seem to be the result of higher wage payments. Instead, firms with stronger worker participation save less because they invest more.

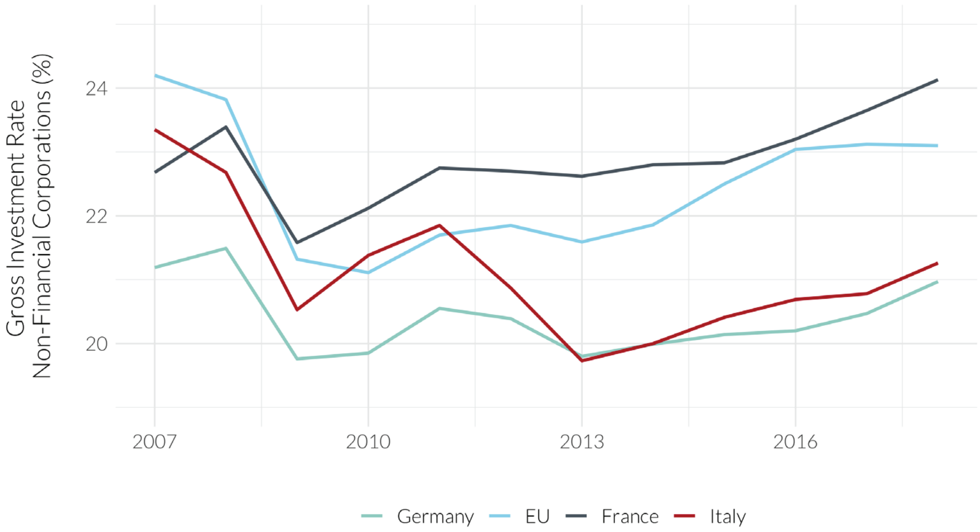
[1] For the methodological and empirical background of this paper see Redeker (2019): *"The Politics of Stashing Wealth – The Demise of Labor Power and the Global Rise of Corporate Savings"*, CIS Working Paper, No 101.

[2] European Investment Bank (2018): *Investment Report 2018/19 – Retooling Europe's Economy*.

[3] Commission (2019): *Mission Letter – Commissioner-designate for Internal Market;* European Commission (2019): *Mission Letter – Executive Vice-President-designate for a Europe fit for the Digital Age*.

[4] Chen, P; Karababounis, L; Neiman, B. (2017): *The Global Raise of Corporate Saving*. Journal of Monetary Economics, Vol.89, 1-19.

Figure 1 – The Trajectory of Private Investment in Major European Economies.



Data: Eurostat.

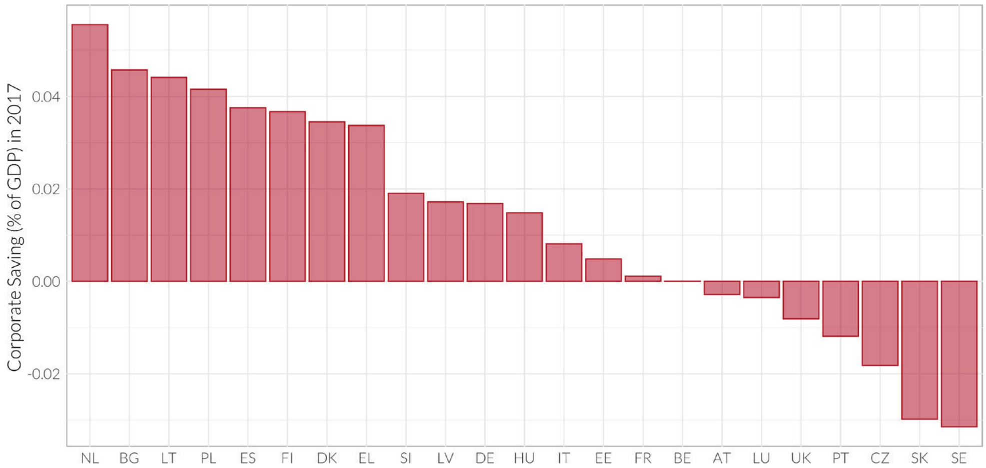
For the Commission this means rethinking its approach to corporate governance and labor market reforms. European corporate governance law provides ample opportunity for strengthening employees' voice in firms' decision-making but so far lacks the bite to do so. Similarly, structural reforms recommended to member states in the context of the European Semester often aim at increasing productivity by effectively undermining the bargaining position of labor. Rethinking approaches at both these levels would not only reduce savings and bolster investment; it would also fit very well into the priorities contained both in the European Pillar of Social Rights and the political guidelines set out by the new Commission President.

2 The rise of corporate saving and why Europe should care about it

In recent years, the corporate sector in most EU countries has turned into a net lender to the rest of the economy. On aggregate, firms in most EU countries as well as in many other advanced economies today, thus, save more than they pay out or invest (see Figure 2).[5] This is a puzzling development. According to standard economic theories, firms should not only reinvest their profits but also go into debt to finance their operations and fund additional investments. After all, it is one of the fundamental ideas of market economies that companies take idle resources and put them to productive use. While single firms or sectors might temporarily deviate from this logic, the corporate sector, on aggregate, should, thus, borrow money from households or the government. Accordingly, firms in most European countries have been net creditors to the rest of the economy until the early 2000s. The fact that they increasingly have stopped doing so has major economic implications.

[5] See also Dao, M.; Maggi, C. (2018): *The Rise in Corporate Saving and Cash Holding in Advanced Economies: Aggregate and Firm Level Trends.* IMF Working Paper, 18/262.

Figure 2 – Corporate Saving of Non-Financial Corporations across Europe in 2017



First, the rise of corporate saving has been a major drag on growth and productivity. In most countries, savings have increased at the expense of firms' investment in physical capital. Several studies also suggest that the increased build-up of cash reserves, in recent years, has prevented firms from undertaking expenditures that could have increased productivity.[6] Second, rising corporate savings fuel economic inequality. These savings are financial assets held by the owners of companies. As company ownership in most European countries is concentrated at the top of the income distribution, rising savings have boosted the income of rich households. At the same time, lower investment spending and stagnating wage payments have weighed heavily on the economic situation at the lower end of the income distribution.[7] Finally, large corporate savings have been a major driver of the macroeconomic imbalances within the Eurozone. While the rise of corporate saving has occurred in many European countries, it has been especially pronounced in countries with large current account surpluses such as Germany and the Netherlands. In these countries, excess savings in the corporate sector, which went unabsorbed by larger government or household deficits, have contributed massively to capital exports and current account surpluses. Excessive corporate savings, thus, constitute a key source of global and European financial instability.[8]

[6] Kim, H.; Kim, B.; Kronlund, M. (2019): *Do Firms Save Too Much Cash? Evidence from a Tax on Corporate Savings.*
[7] International Monetary Fund (2019): *Germany – Selected Issues,* July 10, 2019.
[8] Klug, T; Meyer, E.; Schuler, T. (2018): *The Corporate Saving Glut and the Current Account in Germany.* Ifo Working Papers 280, 2018.

3 The Rise of Corporate Saving and the Demise of Labor Power

Reducing corporate savings could not only support growth and investment but also decrease economic inequality and reduce macroeconomic imbalances in the Eurozone. So, what can be done? To some extent, the rise of corporate saving is rooted in structural factors difficult to address politically such as declining prices for investment goods,[9] increasing insecurity due to technological change and trade conflicts[10] and growing market concentration[11] in key industries. Another important driving factor has been the decline of effective tax rates on corporate profits in many advanced economies. This could be tackled politically but would need to be done mainly at national level. From a European perspective, another approach, therefore, could turn out to be more fruitful: strengthening the bargaining position of labor.

The rationale behind this idea is simple. A number of developments ranging from financial deregulation, heightened global economic insecurity as well as the increased valuation of large savings on stock markets have made it increasingly attractive for firm owners and managers to retain profits and stash them in liquid assets on financial markets. However, this strategy is at odds with the interests of employees, who would prefer surplus profits to be used either for higher wages or real investments that secure their jobs in the long run. What happens to surplus revenues, therefore, also should therefore also depend on the influence that workers and employees have in negotiations about the usage of profits. In fact, our new empirical evidence suggests that the demise of the bargaining position of labor has been a key factor in the rise of corporate saving.

“What happens to surplus revenues also depends on the influence that workers have in negotiations about the usage of profits.”

Starting with a broad overview across time and countries, Figure 3 shows that the rise of corporate savings is strongly associated with the demise of labor power. More specifically, it plots the modelled relationship between aggregate corporate savings and the share of workers and employees who are organized in trade unions in 25 OECD countries. Holding constant all country- and year-specific factors as well as a wide range of other variables it shows that the rise of corporate savings has been especially pronounced in countries in which the influence of trade unions has significantly decreased. According to the most conservative estimates, for example, about 20% of the increase in corporate saving in Germany could be explained by a corresponding decline in trade union density.

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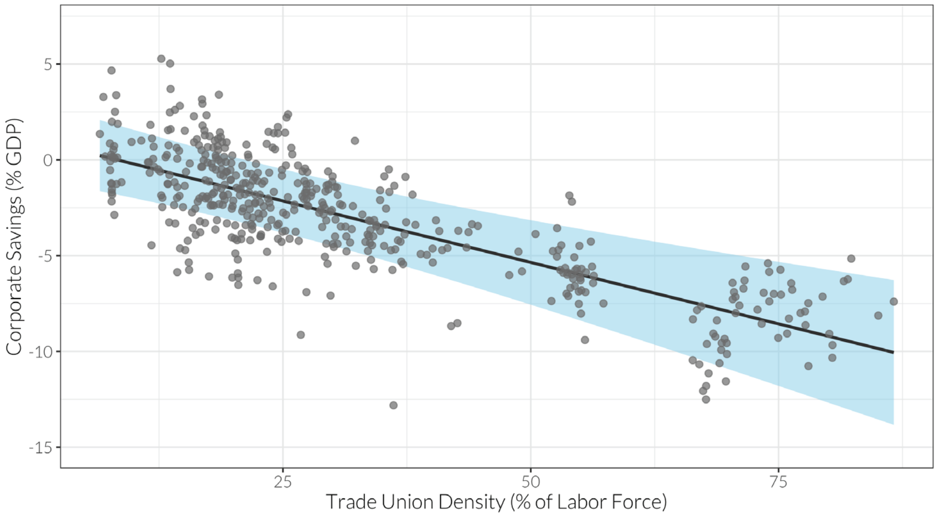
[9] Chen, P; Karababounis, L; Neiman, B. (2017): *The Global Raise of Corporate Saving.* Journal of Monetary Economics, Vol.89, 1-19.

[10] Sánchez, J.; Yurdagul, E. (2013): *Why are corporations holding so much cash?,* The Regional Economist, Federal Reserve Bank of St. Louis, Issue Jan.

[11] Dao, M.; Maggi, C. (2018): *The Rise in Corporate Saving and Cash Holding in Advanced Economies: Aggregate and Firm Level Trends.* IMF Working Paper, 18/262.

Figure 3 – The Relationship between Trade Union Density and Corporate Saving across Time.



Data: Visser, (2019); Chen et al. (2019)[12]

Of course, this broad pattern of correlation could be driven by a range of factors. A key question is, therefore, whether strengthening labor's voice in firms' decision-making does lower corporate saving and lead to more investment. Firm-level data from Germany suggests that it could. The German law on co-determination stipulates that companies with more than 2000 employees must fill half of their supervisory boards with labor representatives.[13] In the German two-tier board system, such supervisory boards are in charge of electing, monitoring, auditing, and dismissing the managing board, which is responsible for the day-to-day operation of the firm. Members of the supervisory boards in addition must be involved in all decisions of fundamental importance to the company such as strategic planning and larger financial decisions. Introducing parity co-determination of supervisory boards in this way substantially strengthens the influence of workers on firms' decision-making. We can make use of this arrangement to track more causally how this increase in worker participation affects savings and investment.

[12] The Figure shows an added variable plot for a two-way fixed effect model with a Prais-Winston transformation and panel-corrected standard errors. It covers the period between 1995 and 2013. In addition, the model controls for foreign direct investment (% GDP): real GDP growth, real interest rates, old age dependency ratios, corporate income taxes, the level of stock market capitalization and the share of routine tasks in total employment.
[13] Companies with less than 2000 but more than 500 employees are required to fill a third of their supervisory boards with labor representatives.

Figure 4 – The Effect of Co-Determination on Corporate Savings in German Firms. Dashed line indicates the 2000 employee threshold over which companies must implement parity co-determination.

Points show average savings for local averages of companies. Data: Compustat.[14]

Based on balance-sheet data from publicly listed firms in Germany, Figure 4 shows that companies just above the 2000 employee threshold, which are legally obliged to implement parity-codetermination, save significantly less than companies just below the legal cut-off. On average, parity on supervisory boards reduces the ratio of savings to total assets by about 4 percentage points.

The German system also allows us to investigate why exactly savings go down. Table 1 shows that – contrary to what one might expect – strengthening the voice of workers in firms' decision-making does not primarily increase wages (at least not to a statistically significant degree). Instead, it leads to somewhat higher expenditure for other forms of labor compensation (i.e. expenses for worker training, pension funds etc.) but, above all, increases firm-level investment in physical capital. This suggests that employees do not primarily use their position of authority to grab a larger share of the revenue pie but to push firms into boosting investment. It is important to note that these findings should be taken with a grain of salt as balance-sheet information on wages and investment tends to be more scattered than for savings. However, they are very much in line with other recent studies that employ different methods and data but also find that co-determination in Germany is associated with higher capital investment and labor productivity.[15]

[14] More formally, the Figure shows the result of a regression discontinuity design (RDD) around the 2000 employee threshold. Savings are measured as cash and short-term assets which could be liquidated in less than a year. The bandwidth for the analysis is chosen based on an optimal bandwidth calculator (see *Imbens & Kalyanaraman, 2012*) and includes 254 observations. For more details and robustness tests see Redeker (2019): *"The Politics of Stashing Wealth – The Demise of Labor Power and the Global Rise of Corporate Savings"*, CIS Working Paper, No 101.

[15] Jäge, S.; Schoefer, B.; Heining, J. (2019): *Labor in the Boardroom.*

Table 1: Effect of Parity-Codetermination on Spending Behavior

Dividends, Staff Expenses & Investment			
	Estimated Effect	p-value	statistically significant
Dividends	-0.02	0.033	√
Staff Expenses (Wages & Salaries)	0.055	0.287	×
Staff Expenses (Other)	0.039	0.001	√
Investment	0.127	0.027	√

Dividends compromise the total amount of dividends declared on all equity capital of the company. Staff expenses (wages & salaries) include all labor expenses that are linked to the direct remuneration of workers. Staff expenses (other) captures forms of indirect remuneration of labor such as employee benefits plans and other social expenditure, pension and retirement expenses as well as social security contributions. The items are scaled by firm size measured in total assets. Investment is defined as the capital growth rate measured in annual changes of total investment (Peters and Taylor, 2017) divided by lagged total assets. Estimate is the average treatment effect at the 2000 employee cutoff estimated with local linear regressions with a triangular kernel and MSE-optima bandwidth. Standard errors are clustered at the firm level.

4 New European Policies for Unlocking the Piggy Bank

Strengthening the bargaining position of workers and employees in firms' decision-making may, we have seen, reduce savings and stimulate investments. From a European perspective, there are two areas which could provide particularly fruitful starting points for achieving this goal: strengthening the legal framework for workers' participation in European corporate law and rethinking the Commission's approach to structural labor market reforms in the European Semester.

> "Strengthening the bargaining position of employees may reduce savings and stimulate investments."

4.1 Strengthening Workers' Participation at European Level

To enable workers to influence firms' savings and investment decisions, European policymakers should seek to strengthen the legal framework for workers' participation in European corporate law. Article 153 TFEU allows the Union to complement and support member state activities in the area of information and consultation of workers (e) as well as the representation and collective defense of workers' interests, including co-determination (f). To this end, the Union can adopt measures designed to encourage cooperation amongst member states but also set minimum requirements for gradual implantation. Arguably, the political hurdles for such measures are high given that they require unanimous support in the Council. Nonetheless, recent years have seen a range of EU activities in these areas, which could be built upon.

On the one hand, existing regulations could be improved. For example, the EU already mandates member states to provide employees in companies of a certain size that operate in more than one European country the right to establish European Works Councils (EWCs). In theory, management should inform and consult these councils on business progress as well as on any significant decision at European level.[16] In practice, however, the directives on EWCs are often criticized for lacking sanctions in case of non-compliance and providing only very weak information and consultation rights. Strengthening the legal framework for EWCs and turning them into tools for active worker participation could, therefore, significantly boost the voice of workers at the European level.

Moreover, the Commission could increase employee influence in companies operating under European law such as Societas Europaea (SEs). Currently, SE regulations and other directives that aim at facilitating cross-border operations and mergers are often criticized for making it too easy for firms to dodge national forms of co-determination by changing to European legal forms.[17] By proactively establishing participation rights in European firms, the Commission could not only prevent legal evasion but also decrease savings by directly strengthening the bargaining position of workers in big European firms.

Finally, the Commission should make employee participation a key priority in its approach to regulating European corporate governance more generally. In recent years, European institutions have often strengthened the rights of other company stakeholders and especially minority shareholders, for example, through the recent Shareholders' Rights Directive. To balance these reforms and strengthen employees' position in firm decision-making, the Commission should aim at setting ambitious minimum standards for workers' information, consultation and participation rights in firms that operate in the EU.

"Commission should set ambitious minimum standards for workers' information, consultation and participation rights."

4.2 A New Approach to Structural Reforms in the European Semester

Besides setting European standards, the Commission also influences national economic policymaking, especially through its country-specific recommendations (CSRs) in the European Semester. In fact, CSRs have been one of the main tools through which the Commission attempts to steer member states towards policies that stimulate investment, productivity and growth.[18]

In the area of industrial relations, CSRs so far often focus on improving competitiveness and the investment climate by reducing employment protection, rendering labor markets more flexible and decentralizing wage bargaining.[19] While such reforms can increase labor productivity, research also shows that they significant-

[16] Directive 2009/38/EC: *Establishment of a European Works Council.*

[17] Importantly, the analysis of data from public listed firms in Germany above, however, does not indicate strategic circumvention of the 2000 employee threshold through changing into SEs.

[18] Verdun and Zeitlin (2018): *"The European Semester as a New Architecture of EU Socioeconomic Governance in Theory and Practice."*, Journal of European Public Policy 25(2) 137–148.

[19] Haas, J.; D'Erman V.; Schulz, D.; Verdun, A. (2019): *Economic and fiscal policy coordination after the crisis: is the European Semester promoting more or less state intervention?* Paper prepared for the 2019 EUSA International Biennial Conference, Denver Colorado 9–11 May 2019.

ly lower the bargaining power of workers and contribute to higher profit shares.[20]

In a context within which rising profits seem increasingly detached from greater investment, the Commission, therefore, should rethink which precise mix of structural reforms can boost growth and employment. Bolstering the bargaining position of labor, for example, through CSRs on strengthening the organizational capacities of labor, calling for more employee participation in corporate decisions and fostering social dialogue could play an important role in making sure that company revenues find their way back into the European economy. Moreover, realigning some of the policy priorities in the European Semester accordingly would not only bring labor market CSRs more in line with the goals of the European Pillar of Social Rights[21] but fit well with the emphasis that Ursula von der Leyen put on social dialogue between employers and unions in her political guidelines.[22]

5 Conclusion

Europe is in dire need of investment. A key problem is that many European companies have ample profits but do not put them to work in the European economy. Instead, corporate saving has been on the rise and has contributed not only to faltering investment but also to economic inequality and macroeconomic imbalances in the EU. One of the main challenges in the current economic environment is, therefore, how to make sure that companies reinvest their money.

The findings of this paper suggest that improving the bargaining position of workers in firms' decision making could provide a new and important strategy to achieve this goal. As employees have strong stakes in the long-term productivity and survival of their firm, they are likely to pressure firms into using revenues for both wage growth and investment if they are put in a position to do so. Both comparative data across countries and more causal evidence provided by a discontinuity in German law on co-determination support this idea.

For European institutions this means realigning priorities. On the one hand, European legislation on corporate governance provides ample room for improving worker participation in big firms operating under European law. On the other hand, country-specific recommendations in the European Semester often undermine instead of improving the bargaining position of workers and employees. Rethinking approaches pursued at both levels, therefore, could not only contribute to higher growth and investment but also reaffirm Europe's commitment to social dialogue and inclusion.

[20] Ciminelli, G.; Duval R.; Furceri, D. (2018): *Employment Protection Deregulation and Labor Shares in Advanced Economies.* IMF Working Paper, (18) 186.
[21] [2017] OJ C428/10.
[22] Ursula von der Leyen (2019): *A Union that strives for more – My agenda for Europe.*

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