A Changing Europe Monitor

Balance sheet inequality – has it gone too far?

A wide dispersion in the size of corporate balance sheets is a common feature of any economy. On the basis of Eurostat data, the average turnover of a small/micro-company employing under 10 workers was EUR230,000 a year in 2015 (the latest data available), while the average turnover for a company with over 250 workers was EUR167mn. SMEs in the aggregate contribute to 50% of total value added and as much of employment. The small-micro companies, with less than 10 workers, on their own contribute 30% of value added and on average as much to employment.

In the last ten-fifteen years, in our view three intertwined factors have contributed to the rise of titans: companies that in terms of revenues or profits are equivalent, or bigger in size, to a middle-high income small country, such as Hungary or Luxembourg. These three factors are the advancement of AI-big data technology, low interest rates and globalisation. None of these factors will really U-turn any time soon in our view, which means titans are doomed to get bigger and more common.

In our view, the aggregate effect of these titans is beginning to have a material impact on economies that go beyond the widely discussed and documented improvements related to investment and productivity, usually associated with multinationals and foreign direct investment. The sheer size of these companies in our view implies that economic variables such as the balance of payment or inflation are directly affected by strategic decisions of relatively few multinationals.

We cannot claim to have the full picture yet, but we sketch here some of the strong trends we think are becoming visible, on the back of the research we have been conducting in the past year.

The very wide gap between the titans and SMEs balance sheets has reached levels that in our view can no longer justify a level plain field between the two. Titans have access to lower cost of capital, their size implies greater benefits from the legal system, faster response to the business cycle and consumer preferences, to name a few. The traditional comparative advantage of being small (flexible and in some sectors greater emphasis on quality), is greatly eroded by the combination of balance sheet size and the new technological paradigm. All this means the distribution of profits is becoming increasingly uneven, and that has repercussions on investment, consumption and will affect productivity in the long run. This process may also be partially influencing already the puzzling low inflation.

There are also political implications from this process. On the back of the fieldwork we conduct across Europe, this trend is one of the factors driving the weakness of the Left. In our view, no popular support for the Left is likely unless the left-wing parties acknowledge and embrace these changes. As the European Parliamentary 2019 elections loom on the horizon, a collapse of the Left may spell undesirable consequences for the long-term prospects of the Union.

Too much corporate balance sheet inequality ?

There is growing popular attention being paid to changes in income inequality, but we find little focus on the widening inequality of means and opportunities in the corporate sector. What is it and why does it matter? In our view, there is a growing polarisation in the size of corporate balance sheets between small-medium businesses and titan companies (those that, either in terms of revenues or profits, have grown equivalent to or bigger than whole countries). We believe these changes matter greatly for economic growth, well-being and, increasingly, also for political developments.

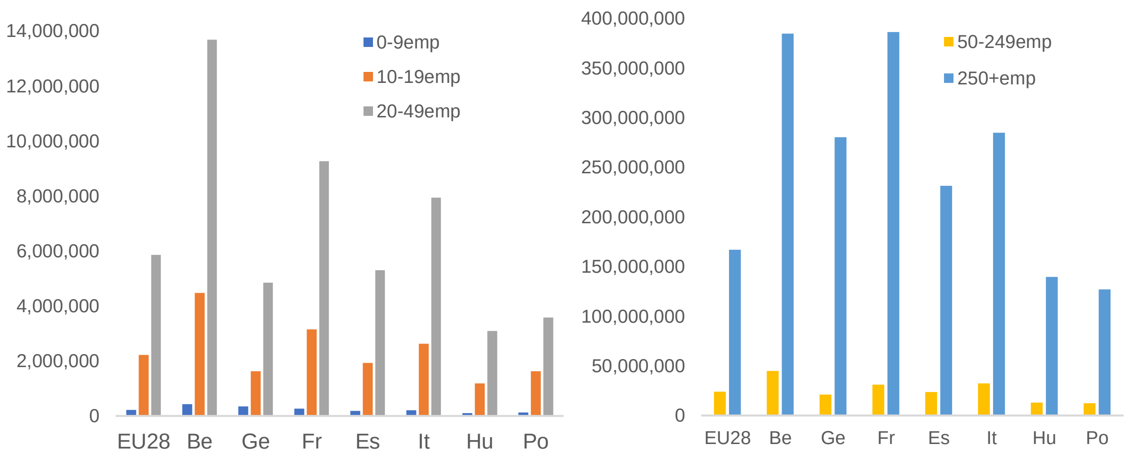
Gathering the data on these issues is not straightforward but, here, we report on some of the research that we have been conducting for the past year. We are conscious of the fact that this is a very broad and complex development and not everything can be discussed in this report, but we aim to begin a conversation on this issues here.

First, let us get back to the basics. In modern market economies, it is normal to have a very large number of small/micro-companies, with under 10 employees, and relatively few large companies. In Europe, companies with under 10 employees account for 93% of all business companies (excluding financial companies). In terms of economic impact, SMEs in the aggregate are very important: companies with up to 50 employees account for half of total employment and around a third of value-added in the EU.

Inequality of balance sheet size, per se, is not a new phenomenon nor one that should surprise. To give you a sense of the status quo we show below average turnover, in euros, for a few industrial countries in the EU for 2015 (we used Eurostat data and that is the latest year available). A small/micro-company on average has turnover of EUR230,000 in the EU, while a company of over 250 employees on average has turnover of EUR167mn.

However, what is new in our view is the increasing number and magnitude of titan companies: that is companies that in terms of revenues or profits have grown to become as large to the GDP of a medium-sized country such as Hungary, Luxemburg or Lithuanian. In the aggregate, the 100 largest companies in terms of 12-months rolling profits, have a balance sheet equivalent to USD3.1trn according to the data we collected from Bloomberg: that means an equivalent size in between the UK and Germany.

Average turnover, EUR, 2015



Source: Eurostat. The data for the table below comes from Bloomberg, World Bank and ADA economics calculations

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Ranking	Country/Company	12m profits/12m NGDP in 2000, USDbn	Ranking	Country/Company	12m profits/12m NGDP in 2016, USDbn
1	United States	10,284.8	1	United States	18,036.6
2	Japan	4,887.5	2	China	11,007.7
3	Germany	1,950.0	3	Japan	4,383.1
4	United Kingdom	1,635.4	4	Germany	3,363.6
5	France	1,368.4	5	United Kingdom	2,861.1
6	China	1,211.3	6	France	2,418.9
7	Italy	1,141.8	7	Italy	1,824.9
8	Canada	742.3	8	Canada	1,552.8
9	Brazil	655.4	9	South Korea	1,377.9
10	Mexico	648.5	10	Russia	1,326.0
11	Spain	595.4	11	Australia	1,243.2
12	South Korea	561.6	12	Spain	1,193.0
13	Netherlands	412.8	13	Mexico	1,148.1
14	Australia	409.3	14	Indonesia	861.9
15	Russia	276.7	15	Turkey	859.4
16	Turkey	273.0	16	Netherlands	750.3
17	Switzerland	271.7	17	Switzerland	670.8
18	Sweden	259.8	18	Saudi Arabia	646.0
19	Belgium	237.9	19	Argentina	632.3
20	Austria	196.4	20	Sweden	495.7
21	Saudi Arabia	188.4	21	Poland	477.1
22	Indonesia	180.6	22	Belgium	455.1
23	Poland	171.9	23	Norway	386.6
24	Norway	171.3	24	Austria	377.0
25	Denmark	164.2	25	Denmark	301.3
26	South Africa	136.4	26	Israel	299.4
27	Israel	132.3	27	Ireland	283.7
28	Greece	131.7	28	Chile	240.8
29	Finland	125.5	29	Finland	232.4
30	Portugal	118.4	30	Portugal	199.1
31	Colombia	99.9	31	Greece	194.9
32	Ireland	99.9	32	Czech Republic	185.2
33	Chile	78.0	33	New Zealand	175.6
34	Czech Republic	61.5	34	WAL-MART STORES	124.6
35	EXXON	58.8	35	Hungary	121.7
36	GE	55.5	36	Slovakia	87.3
37	New Zealand	54.4	37	AT&T INC	86.9
38	Hungary	47.2	38	APPLE INC	84.0
39	MOTORS	40.6	39	VERIZON COMMUNIC	74.6
40	LVMH	37.2	40	SAMSUNG ELECTRON	70.3
41	ALTRIA	36.4	41	Luxembourg	56.8
42	FORD	35.3	42	COMCAST CORP-A	55.9
43	ATT	33.3	43	ALPHABET INC-A	55.1
44	WALMART	33.0	44	Costa Rica	54.8
45	IBM	31.9	45	BERKSHIRE HATH-A	54.5
46	Luxembourg	21.4	46	NIPPON TELEGRAPH	54.3
47	WORLDCOMM	21.2	47	MICROSOFT CORP	52.2
48	Slovakia	20.7	48	JOHNSON&JOHNSON	50.2
49	Slovenia	20.3	49	AMAZON.COM INC	47.7
50	MICROSOFT	19.1	50	NESTLE SA-REG	46.3
51	PPANASONIC	19.0	51	TOYOTA MOTOR	45.6
52	SONY	18.1	52	VOLKSWAGEN AG	45.4
53	P&G	17.9	53	UNITEDHEALTH GRP	43.4
54	PG&E	17.5	54	Slovenia	42.8
55	INTEL	17.5	55	ROYAL DUTCH SH-A	42.6
56	HONDA	16.8	56	Lithuania	41.4
57	MERCK	15.2	57	PFIZER INC	40.5
58	Costa Rica	14.9	58	IBM	38.3
59	GTE	14.4	59	FINATIS SA	38.0
60	HISTOIC TW	14.0	60	FONCIERE EURIS	38.0
61	SEARS	13.9	61	INTEL CORP	36.2
62	COCACOLA	13.8	62	DAIMLER AG	35.4
63	HP	13.7	63	ROCHE HLDG-GENUS	34.9
64	PFIZER	13.7	64	PEPSICO INC	34.6
65	BRISTOL	12.9	65	PROCTER & GAMBLE	32.5
66	PEPSICO	12.2	66	HOME DEPOT INC	32.3
67	KROGER	11.9	67	SOFTBANK GROUP C	31.5
68	BASF	11.8	68	NOVARTIS AG-REG	31.0
69	MOTOROLA	11.8	69	CISCO SYSTEMS	30.9
70	Lithuania	11.5	70	GENERAL MOTORS C	30.0

In addition, titans can be found across sectors, while in the past the very large companies were clustered in the utilities sectors or banking, both more heavily regulated than other areas of the economy.

The table above is meant to give you a sense of the changes since of the relatively recent past comparing companies and countries. For the purpose of this report, we only took 1-year rolling profits, rather than revenues, and compared it with nominal GDPs. Looking at the ranking of the top 70 biggest country/company in 2000 and 2016 (to have full GDP data) shows that in both years, the top-30 positions are taken comfortably by the largest countries: the US, China, the Eurozone, and so on. However, beyond the 30th positions, some large companies begin to appear.

Back in 2000, we counted 28 companies as large as some smallish (not super-small) countries, with an aggregate value of USD 600bn – approximately the GDP of Mexico back then. In 2016, the picture is similar, but the number of companies rises to 31 and the aggregate value to USD 1.5trn, equivalent to the GDP of Canada. Importantly, when we measure the total number of employees of these 31 companies, we estimate a total size of under 10m workers – less than one-third of Canada's population currently. If we look at the top 100 companies in terms of profits, we get an estimated 17mn employees – which is a little more than half what the UK-Germany produce with that magnitude of GDP.

Why titans will likely get bigger and more common: rates, technology and trade

There are three key factors that support in increasing polarization of corporate balance sheet size as the titans get bigger, while the small-micro companies struggle to gain ground.

First, globalisation helps successful companies grow larger – about 30 years have passed since the first wave of trade liberalisation, so the benefits have widened. Admittedly, we are yet to see the impact of Brexit and the Trump trade strategy, but we suspect that neither is going to turn globalisation around completely.

Secondly, in the past 10 years, huge advancements have been made in collecting and using big data, as well as the increasing widespread use of internet platforms and growing efforts to improve artificial intelligence. This type of technology, coupled with balance sheet size, generates enormous competitive advantages in favour of the titans because it allows them to sustain/create/use wide networks to reach consumers, respond to consumption changes rapidly and be more visible to customers compared with medium/large incoming competitors.

Thirdly, there have been ultra-low interest rates globally since the 2008 crisis, which allow already large companies to amplify their market power by increasing leverage more rapidly and more cheaply than what a medium/large company can do.

Why size matters at the two extremes of the balance sheet distribution

In our view, the gap between the small/micro companies and the titans is so large that there is no longer a level playing field between these two segments: the titans have too much going in their favour. This process has serious repercussions for the economic prospects of countries because SMEs generate employment, because countries need a large inflow of new companies every year to replenish those that close down and the survival rate for small companies is low (around 1/5 is still in business after 5 years on average) and because in our view a flourishing SME sector is necessary in the long term to support productivity growth and accommodate greater participation of women in the work force.

The stronger titans get, the less profits will be accumulated in the small-end of the balance sheet spectrum and this will mean less investment, less employment, less diversity – which ultimately means less competition.

The problem is not only that profits will become increasingly unevenly distributed in most countries, but that an increasing amount of liquidity will be trapped because of the titans' large balance sheet in their cash buffers and as they distribute dividends, the cash ends up in private pension schemes, and in a sizeable share remains locked in until the retirement age. On the contrary, when profits in the SMEs sector are abundant, they find their way back into the economy quickly, because SMEs fund most of their CAPEX via retained earnings and because small entrepreneurs tend to work until an advanced age, and thus the liquidity they create is constantly reinvested in the economy, via consumption or investment, and only in small fraction parked into cash until retirement.

The competition between titans and small companies is uneven.

Here are the most important factors, in our view.

Different borrowing costs

There is a well-known and justified gap in borrowing costs and access to capital between large and super-large companies and small-medium sized ones. This is not undesirable, *per se*, but the repercussions are profound, as we enter the tenth year of ultra-low interest rates globally, and many more could be ahead.

Pricing strategies and the chances of survival during downturns

There are serious differences in the chances of survival and pricing strategies during times of slow growth due to balance sheet size. A small company, because of its size, can only withstand an abrupt change in demand for a limited number of years before it is forced to either radically change strategy or shut down. A large company, on the other hand, can weather protracted periods of slow growth and even business losses. In fact, the bigger the balance sheet, the more it can engage in aggressive pricing strategies to change the market landscape; while a small company can only do so for very small periods of time and it is unlikely to affect the whole market dynamic.

We are all equal before the law, but the benefits are not evenly spread

Recourse and benefits from the legal system differ significantly between the two.

Titan companies have great flexibility in the conditions they impose on contract with their suppliers and customers to the point that even seemingly unreasonable conditions cannot be challenged easily because of the market power a large/titan company has. This kind of freedom – which ultimately results in greater balance sheet advantages – is simply not available to a small company.

There is also a difference in the accessibility of the judicial system: suing a large company can be lengthy and expensive; while suing a small company maybe lengthy, but not difficult if the balance sheet difference is large enough. This works on the opposite side as well: a titan-company can use its legal capabilities to fend off potential competitors before they grow big.

Asymmetric information and lobbying power

In the era of big data and artificial intelligence there is an increasing gap in the access to, and ability to use, market information, between those that have it and those that do not. Perhaps more importantly, there is a divergence in lobbying power between the super-big and the super-small. The super-big are more visible, more organised and can steer policymakers to best respond to their business needs; while the super-small are too disaggregated, imperfectly informed and thus it is even more difficult to tailor policies for them.

Consider the current best practice recommendations to support the industrial sector: lower corporate taxes and a lower labour tax wedge – every company can benefit, but the balance sheet gain of a large company are much greater than that for a small company, which means, in turn, that the former, on the margin, can gain market power; while the latter simply survives an extra year, without really being capable of genuinely turning around its business model.

We should worry if SMEs become too squeezed

We have tried to underscore the key elements that in our view imply the level playing field has become too skewed in favour of titans. The combination of large cash pots and the new technology fundamentally erode the comparative advantages of being tiny. In the past, being small meant you had an end due to greater flexibility in business model, adaptability to customers' needs and, in some sectors, smaller volumes but higher-quality products. These comparative advantages are also vanishing in today's business conditions. Very large companies, by virtue of their size, are inflexible, but their abundance of cash allow them to adapt faster to customers' preferences and business conditions, and their widespread market reach makes it more difficult for small businesses to stand out, even when the product they offer is higher quality.

The more SMEs struggle, the more we should see investment lagging behind the recovery – something that indeed has been the case for many years since the last financial crisis. This polarisation of balance sheets may also be part of the explanation of the persistent low inflation. In the past, inflation and a positive output gap had a strong correlation. In a country where SMEs are profitable and abundant, strong domestic demand lead them to push prices up, which in turn fuels further growth via investment and consumption. However, in a country where there is increasing polarisation between the very large and the small, and profits are increasingly flowing into the large-end of the balance sheet distribution then inflation may have an increasingly loose correlation with the output gap.

Titans can decide their pricing strategy on the basis of demand considerations, just like SMEs, but can also price to gain market share for as long as their cash buffer allow them. In a situation where large companies want to gain market share, SMEs' pricing strategy will depend on demand conditions: if demand is strong, they may be able to simultaneously enjoy high volume and high prices, but if demand is weak they will have to keep prices to and lose profits. Whether demand is strong or weak isn't necessarily closely correlated with the output gap, which instead is a measure of overall GDP performance, not of household incomes nor of strictly household consumption.

The Left debacle is also the result of the growing polarisation of balance sheets

We routinely discuss preferences on taxation and overall economic conditions with active voters across the income spectrum around Europe as part of our information gathering, which is the backbone of our economic analysis.

In the past year, we have noticed recurrent patterns across countries:

1. Regardless of how well an economy is performing in terms of GDP growth, we have noted a recurrent complaint from small entrepreneurs on how difficult it has become to run a business. In the vast majority of cases we discussed on the ground, people do not see a credible response to this problem from traditional left parties, so they tend to either shift in favour of centre-right policies (as they hope lower taxes will help) or into more extremist-nationalists parties (as they identify the more intense business challenges with the problems brought, in their view, by the EU related to bureaucracy, changes of regulation, labour dumping and greater globalisation).

2. Except in countries that have seen a strong and uniform income convergence boost such as the Czech Republic and Poland, voters are not particularly favourable to a flat tax system and some element of proportionality in the corporate sector tax structure is

welcome. That said, voters tend to underscore a difference between that is considered "legitimate" degrees of business success, which ranges from no profit to profits in the tens of millions of Euros a year, and what is seen as a completely different situation, for companies that earn billions of Euros. Again, this tends to push voters towards centre-right parties, as most believe (fairly correctly, in fact) that the left-wing parties would be unable to capture the subtlety related to size: most entrepreneurs, no matter how small, want a tax system that is created in favour of companies that can go from zero to many millions of turnover without incurring headwinds from higher taxes. Historically, that has not been the view of the left.

3. Most people see the left as stuck on debating the details of current/past/future labour regulations, while for most there are many aspects related to jobs that are of equal importance and need a solution: wage levels, training, flexibility, pension contributions, accessibility of mortgages, social safety nets for small (women) entrepreneurs and so on. Importantly, even traditional left-wing voters give a high priority to the importance of nourishing a healthy business sector – since those that live in areas that are de-industrialised crave jobs and opportunities as much as they want a comfortable living environment (we noticed the same answers in Italy as in Eastern Germany, for example).

4. Young disenchanted voters tend to give two types of explanations on why they don't want to participate in elections. First, they claim that none of the parties running represent them sufficiently. Secondly, they claim that the State not only is cutting back on the services it provides to them (many countries have seen cuts in pensions, healthcare and so on), but also deprives them of the possibility of building a career as entrepreneurs, as for young people with low education beginning to run a business and grow it into a successful endeavour is very challenging.

In our view, for as long as traditional left parties do not embrace these profound changes taking place in the industrial structure of Europe and voters' interpretation of them, there cannot be a return of the left in any meaningful way. This poses a major challenge for Europe, as the centre-left is also the strongest supporter of the European project as it was originally designed and, thus, continuing erosion of their popular support will inevitably create imbalances in the direction Europe will follow in the future.

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