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**Working Paper**

# The Politics of Financial Development. The Case of Austria

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WORKING PAPERS

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## THE CASE OF AUSTRIA

FRANZ R. HAHN

187/2002

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# THE POLITICS OF FINANCIAL DEVELOPMENT

## THE CASE OF AUSTRIA

### Abstract

This paper is aimed at explaining why Austria has developed a financial system which is that much relationship-based and that little market-based. In so doing we apply the control view of corporate governance. This view states that the managements' or incumbents' powers to disenfranchise all kinds of outsiders be they outside stakeholders such as banks or outside shareholders root in the interplay of incumbents and politics. The driving force behind the evolution of financial development in many countries over the last century has been politics aimed at serving the interests of the powerful and wealthy incumbents. In this context, the overlap of interests between the two major interest groups, organized small– and medium-sized business and organized labor, is identified as the most important factor that has shaped the financial system in Austria since WW II. Organized business' leaning towards relationship-based rather than market-based external financing roots primarily in the specifics of the governance structure of the great majority of Austrian firms. Nearly 95 percent of the Austrian businesses are small- and medium-sized, most of which are run by the owners themselves or by the members of the company-owning family. Only the few larger Austrian companies, mostly former state-owned companies, and the larger Austrian banks and insurance firms are run by managers who may at best be small shareholders of the companies they are in charge. The corporate control view taken in this paper provides a perfectly rational underpinning for the small business owners' dislike of capital markets, particularly of the stock market, and for their leaning towards bank lending. The incumbent manager-owner in need of outside funds will tap first those sources which leave her into the driver's seat at the lowest cost. In this context, secured debt is the prime candidate. For the borrowing incumbent manager-owner, secured debt has the advantage over unsecured debt (i. e., bonds) or shares in that collateralized lending induces the lender not too closely dog-watch the borrowers' activities.

JEL Classification: G20, G28, G30, G38

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*"Shareholders are stupid and impertinent – stupid because they give their money to somebody else without any effective control over what this person is doing with it and impertinent because they ask for a dividend as a reward for their stupidity".*

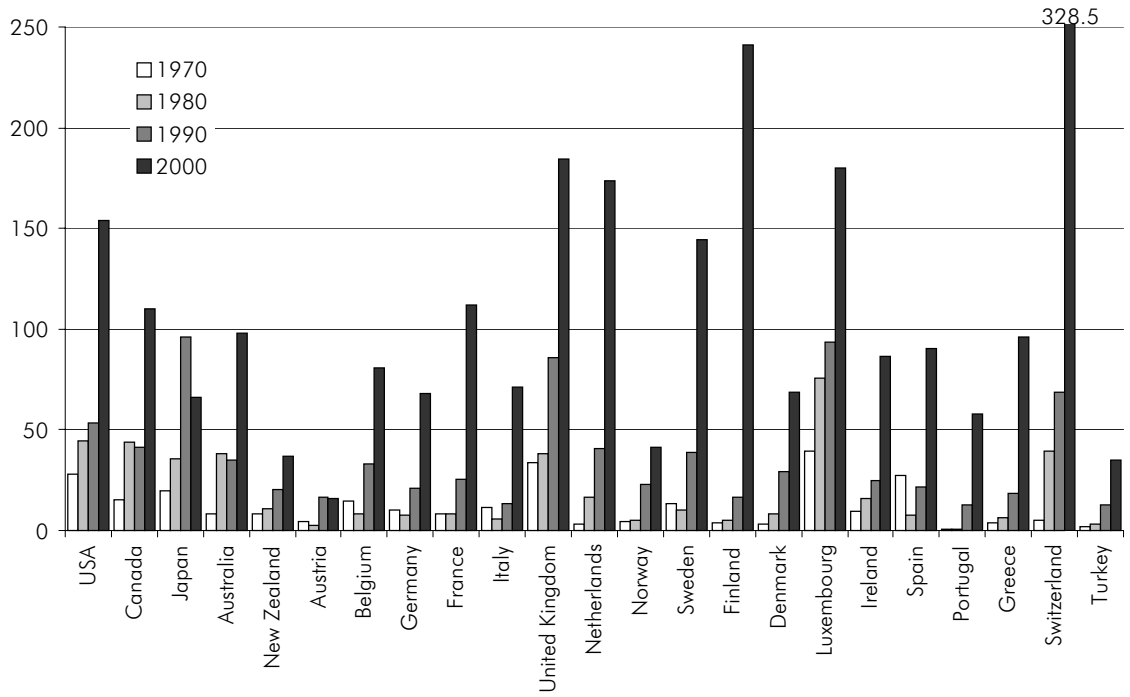
*Carl Fürstenberg, 1855 – 1933*
*German Banker*

# 1. Introduction

Consensus is that financial efficacy propels economic growth. Since the 1990s increasing support, academic and otherwise, has been given to the notion that financial efficacy proceeds when financial markets expand. Thus a financial system is viewed as advanced when it is predominantly based on unfettered arm's length financing, that is to say, if the prime source of corporate financing is market-based, bond or stock, with financial intermediation via traditional bank lending coming second. Oddly enough, in the 1980s the opposite was stated as the ultimate financial advancement. With Japan as the then world's economic champion, the relationship-based financial system with its long-run orientation, to many at the very heart of Japan's rise, was said to be by far more efficaciously and thus more suitable to promote economic growth than the short-sighted, frenzy-ridden financial market systems of the USA or the United Kingdom. Importantly, the recent empirical literature shows that the view that stock market development spurs economic growth is, at least as far as the OECD countries are concerned, at odds with the data. For instance, Hahn (2002A) re-evaluates the finance-growth nexus for the group of high income countries over the period 1970 through 2000 by using new panel econometric techniques. Though in accordance with the view that finance matters as a growth factor (e. g., there is a positive linkage between bank credit and economic growth) the findings of this work give rise to question the robustness of the positive linkage between stock market development and economic growth. The point is that when price effects are appropriately controlled for the positive relation between stock market activities and macroeconomic growth across the OECD countries disappears in terms of statistical significance. This may not be all that surprising, for the claim that financial development equals stock market expansion cannot easily be reconciled anyhow with the huge diversity of stock market development within the broad set of fast-growing, industrialized countries. Take, for example, Austria and the USA and compare their productivity growth and stock market development over the last thirty years. One will find that in both countries overall productivity did expand, on average, by a margin of 2 plus percent annually (Austria 2.5 percent; USA 2.2 percent), while distinction in stock market development couldn't be larger. In the USA, stock market capitalization relative to GDP, the standard measure of market size, climbed from 25 percent (1970) up to 150 percent (2000), in Austria only from 7 percent to meager 15 percent (Figure 1). One may well wonder: How come? How is it possible that advanced economies can deviate that much in financial matters. Is it possible that the same function of a financial system can be performed by different institutions, that is, markets and banks?

In this paper we are trying to find out whether economic theory has something to say as to explaining why OECD countries differ that much in the organization of their corporate financial activities. We are particularly interested in understanding why Austria has developed a financial system which is that much relationship-based and that little market-based. Is there a rationale to it or is it just plain chance? We start dealing with what has been termed by Myers – Majluf (1984) as "pecking order of finance". This notion relates to the fact that new investments are financed first by retained earnings, then by loans, and only in the last instance by new share issues. In Section 3, we survey the insights the recent research work exploring the interrelatedness of corporate finance and corporate control has yielded. In addition, we analyze in some detail the importance of the political system for the structure and functioning of the financial system, with the main focus on Austria. In understanding the Austrian case, the inclination of the political establishment to align itself with incumbent management receives special attention. Section 4 deals with the topic of structural change and the allocation of funds within a financial system which favors incumbents and their interests. Section 5 concludes.

*Figure 1: Stock Market Capitalization as Percent of Gross Domestic Product*




Source: Hahn (2002A).

## 2. The Pecking Order of Finance

Consider an incumbent company which is lucky enough to sit on retained earnings, collected from previous projects, waiting for use. One option for the company's management is to divert the "free cash flow" to the shareholders or company owners as a dividend payment. In so doing, the management let outsiders decide what to do with the internal funds (consume or re-invest). Another option is to re-invest this money directly. In this case, there are again two ways to pursue, namely (a) to invest the internal funds into the company's own new projects or (b) to channel them to other firms with a shortfall of cash flow below profitable investment opportunities. In the latter, the firm engages in mergers and acquisitions thereby financing external activities directly. Empirically we see that retained earnings of incumbent firms are mostly used for internal finance purposes. When internal funding does not cover the expenses fully the incumbent firm usually approaches financial institutions such as banks to fill the gap. For mature companies, bond and share finance is the least important corporate source of external funds. Mayer (1988) was among the first to not only document the empirical relevance of the finance pecking order for the leading industrialized countries on the basis of flow-of-funds data but also stress forcefully the prominence of internal finance. Though the role of internal funding may have been overstated by Mayer's method of calculation, subsequent analyses show clearly that retention is by far the most important means of corporate finance. For example, when depreciation attributable to loan-financed investment is properly controlled for Hackethal – Schmidt (1999) find that over the period 1970 through 1996, internal finance accounts for 88 percent of gross fixed investment in Germany, and for 89 percent in the USA (Table 1 and Table 2). In both countries, over the same period bank loans is the second most important source of funds (Germany 73 percent; USA 65 percent). Approximately the same figures prove valid for Austria, with internal funds accounting for more than 90 percent of gross fixed investment (Table 3). Even in the USA with their strong tradition of arm's length financing, stock markets are only used as source of external funding at and shortly after the initial public offering as Rajan – Zingales (1998) point out. What's more, mature firms tend to repurchase shares so that in the aggregate the financing contribution of the stock market often turns negative. Hellwig (2000) argues that for mature firms the financing contribution of loan finance is also negative as loan renewals fall short of loan repayment. However, the advanced, industrialized countries couldn't differ more in the source firms are turning to first when they are in need of additional, that is, external funding. In the United Kingdom, for instance, first choice of companies is the bond market, in Japan and Continental Europe companies prefer bank loans to bonds.

At the microeconomic level, the importance of internal finance can be measured by the extent to which fixed business investment is made possible or constraint by the availability of free cash flow. Empirical evidence is paramount reflecting a very high sensitivity of firm investment to cash flow (see, for example, Fazzari – Hubburd – Peterson, 1988; Elston, 1997). In general, the smaller the business the more pronounced the cash flow sensitivity of investment. For this reason, internal funding is key to fixed investment activities in Austria since more than 90 percent of all Austrian companies are small-sized by international standards.

## *Table 1: Financing by Instruments*

*As percent of physical investment*

| | 1970 to 1974 | 1975 to 1979 | 1980 to 1984 | 1985 to 1989 | 1990 to 1996 | 1970 to 1996 |
|---|---|---|---|---|---|---|
| USA | | | | | | |
| Internal finance | 71 | 82 | 83 | 93 | 103 | 89 |
| Bank loans | 64 | 61 | 64 | 75 | 62 | 65 |
| Non-bank financial institution loans | 15 | 19 | 19 | 26 | 36 | 25 |
| Bonds | 39 | 38 | 37 | 55 | 62 | 49 |
| Commercial papers | 4 | 4 | 7 | 11 | 15 | 9 |
| New equity | – | – | – | – | – | 15 [1)] |
| Germany | | | | | | |
| Internal finance | 77 | 96 | 94 | 98 | 83 | 88 |
| Bank loans | 62 | 74 | 76 | 76 | 75 | 73 |
| Loans from insurance companies | 10 | 11 | 10 | 10 | 8 | 9 |
| Bonds | 7 | 5 | 5 | 7 | 8 | 7 |
| New equity | 3 | 3 | 3 | 4 | 5 | 3 |
| Japan | | | | | | |
| Internal finance | 50 | 72 | 71 | 76 | 75 | 70 |
| Bank loans | 102 | 152 | 152 | 161 | 172 | 152 |
| *From public financial institutions* | *9* | *16* | *16* | *20* | *29* | *20* |
| Bands | 8 | 14 | 12 | 12 | 20 | 14 |
| Commercial papers | 0 | 0 | 0 | 9 | 11 | 6 |
| New equity | 4 | 4 | 4 | 7 | 2 | 4 |

Source: Hackethal – Schmidt, 2000. – 1) 1988 to 1995.

## *Table 2: The Importance of Long-term External Funds and Securities*

*As percent of physical investment*

| | 1970 to 1974 | 1975 to 1979 | 1980 to 1984 | 1985 to 1989 | 1990 to 1996 | 1970 to 1996 |
|---|---|---|---|---|---|---|
| External funds | | | | | | |
| Germany | 81 | 93 | 95 | 97 | 95 | 93 |
| USA | 137 | 137 | 141 | 182 | 189 | 163 |
| Japan | 114 | 169 | 169 | 189 | 203 | 176 |
| Securitized funds | | | | | | |
| Germany | 12 | 9 | 8 | 11 | 13 | 12 |
| USA | 42 | 42 | 41 | 45 | 48 | 45 |
| Japan | 10 | 10 | 10 | 15 | 16 | 13 |

Source: Hackethal – Schmidt, 2000.

## *Table 3: Financing by Instruments in Austria*

*As percent of physical investment*

| | 1996 | 1997 | 1998 | 1999 | 2000 | 1996 to 2000 |
|---|---|---|---|---|---|---|
| Internal finance | 95 | 93 | 92 | 89 | 91 | 92 |
| Bank loans | 27 | 17 | 23 | 23 | 31 | 24 |
| Non-bank financial institution loans | 0 | 0 | 0 | 1 | 0 | 0 |
| Bonds | -4 | 18 | 0 | 10 | 4 | 6 |
| New equity | 2 | 2 | 2 | 2 | 1 | 2 |

Source: Zotter (2002), own calculations.

Given this observation, the following questions arise quite naturally: Is there an economic rationale for the motivation of the seemingly global predominance of internal finance? What are the circumstances under which internal funding is efficient? And, finally, why share advanced economies the desire to use internal funds as prime source of corporate finance and differ so much in their choice of prime source of external finance? If we find answers to these questions it should then be a comparatively easy task to figure out whether or not some rationality can be attached to the financial specifics which have evolved in Austria over the last fifty years.

## 3. Financial Development and Corporate Control

Traditionally, corporate governance economics is seen as a branch of applied contract theory (Hellwig, 2000). The recent corporate governance literature has, methodologically, close links to the theory of incomplete contracts as developed by writers such as Aghion – Bolton (1992), Dewatripont – Tirole (1994), and Hart (1995). The early literature on corporate governance instead favors the complete-contract approach (e.g., Jensen – Meckling, 1976).

The notion of "residualness" is key in the modern corporate governance literature. Ownership, for example, is defined as a "residual control right", that is to say, as "the right to dispose of the object in question in all those circumstances for which no other control rights assignment has been specified" (Hellwig, 1998A). The concept of residualness is also center in the control view of corporate governance as outlined by Hellwig (2000, 1998A). In this context, the term "residualness" circumscribes the managements' or incumbents' powers to disenfranchise all kinds of outsiders be they outside stakeholders such as banks or outside shareholders. In all governance systems there seems to be a vital interest of the incumbent management, or insiders, to immunize themselves against interference from outsiders of all kinds.

This view is somewhat at odds with the mainstream as surveyed by Shleifer – Vishny (1997). According to Hellwig (1998A, p. 1) the mainstream view rests on the notion that (i) the corporate sector needs external funds for investment, (ii) the financial system channels such funds to the corporate sector from the household sector, and (iii) in this system the interests of external providers of funds are safeguarded through control rights giving them scope for interfering with management misbehavior. Obviously, this view overlooks or does not take seriously that the insider-management is usually able to invent the game anew whenever it pleases them by changing the rules of the game to the disadvantage of the outsiders or by introducing new moves to put them ahead of the game. In my opinion, paying no or too little attention to this critical element of the insider-outsider subgame in the overall corporate control mechanism interferes substantially with the endeavor to fully understand the overall relation between a company and its outside environment, that is, outside stakeholders and/or outside shareholders.

Rajan – Zingales (2001A) propose an interest group theory of financial development which happens to be closely related to the corporate control view as put forward by Hellwig (1998A). They state that the incumbency or insider principle together with politics play the leading part as to

which direction a country's financial system takes. In other words, the driving force behind the evolution of financial development in many countries over the last century has been politics aimed at serving the interests of the powerful and wealthy incumbents. Their interest group theory of financial development can be seen as a first attempt to use the political economics toolkit to shed new light on core questions of finance such as why financial development can differ so much between countries at similar levels of economic and industrial development, and why the same forces that lead to financial development can also cause its reversal. In this approach politics is seen as a means (ab-)used by the rich and powerful incumbents to shape financial development in such a manner that the incumbents' capability of taking advantage of their controlling powers is not unduly restricted. However, it depends on the economic circumstances if the incumbents exert their powers to retard financial development or to promote financial markets expansion.

An incumbent industrialist does not benefit at all from financial markets development when growth can be maintained by financing new projects entirely out of retained earnings with no outside funding needed. Even if the incumbent should fall short of cash to fund desired investments fully on his own, he could easily raise external funds on the grounds of available collateral from existing projects and of his prior reputation, respectively. This will most likely be the case if the economy as a whole is in a somewhat closed status shielded largely from outside influences, that is to say, from foreign competition. Given a closed economy, the incumbents' advantage over the entrants is that incumbents are more capable than newcomers of transferring reputation, collateral and business connections, which the former possess plenty of, into rents giving them a headstart hard to catch up with for all sorts of outsiders. Thus, it doesn't wonder that incumbents often favor strongly a financial system which is relationship-based rather than market-based. Since markets tend to be more democratic and less repulsive to newcomers, a relationship-based financial system is more likely to allow incumbents to harvest rents uncontested by bringing their connectedness to bear.

If, however, the economy is exposed to openness, at least somewhat, and thus to outside competition it might well be in the interest of the incumbents to lobby for financial markets expansion. Foreign contestants will soon let rents melt away due to increasing competition in the very segments of the economy where incumbents used to pocket the highest rents. Since openness does frequently encompass not only free current accounts but also free capital movement domestic companies are allured to increasingly finance their investment projects by tapping foreign capital markets with lower-than-domestic transactions costs. This usually leads to a change of mind of former sturdy opponents of financial markets development. This also applies to the financial industry itself. Commercial banks and insurance firms in Continental Europe used to shield their home-markets quite successfully from outside competition thereby retarding financial markets development in Europe substantially. European banks and insurance companies did so because the protected, highly regulated domestic markets had been a garden of Eden for rent-seekers like them. As financial liberalization went international and rents in certain banking segments melted European financial institutions changed sides and became zealots of the "free capital markets movement". The prospect of new rents (i. e., wholesale banking, investment banking) worked wonders and helped a lot get over the loss of old ones (i. e., retail banking). Let by-gones be by-gones.

Though openness may smooth the way for establishing a market system, it can also trigger a reversal of the free market movement when the demand for insurance and protection becomes irresistible. Competitive markets are often accused of destroying old relationship-based structures of insurance while not providing enough protection against risks which come naturally with a more advanced competitive outside environment. Risks created by the expansion of markets are all too often hard to be diversified away. In good times, this lack of insurance is usually not much of an issue, neither politically nor economically. This changes when bad times roll in quickly turning insurance to a top-notch political topic. As put in Rajan – Zingales (1999B), competition when coupled with the lack of commitment that leads to incomplete contracting and free-riding makes it hard for markets to provide the necessary cross-subsidies that mitigate its harshness particularly at times when they are needed most, that is to say, during bad times.

There appears to be a consensus in the recent literature that both the insider-principle (or corporate control view) and politics aimed at serving the interests of the incumbents are critical to come to grips with what financial development really drives. In the following section, we will use this theoretical framework to explore in greater detail the structure of the financial system in Austria. In so doing, we will also, as announced above, pay attention to the puzzle why the major sources of external funding differ from advanced country to advanced country while the incumbents' preference of internal funding appears to be universal.

## 3.1 The Interplay of Politics, Business Groups, and Organized Labor

Vested interests to be effectively represented usually takes the organizational form of a pressure group. The prime goal of the latter is not only to maintain influence in the political arena but also to sustain a substantial say when the political agenda is about to be set. It goes without saying that incumbents (or insiders) are way better positioned to corporate their interests and thus make their voice heard than newcomers (or outsiders).

It is said that Austria belongs to those countries with the highest degree of corporatization of economic and social interests. We do not take pains to prove the validity of this claim here but we take it as a widely undisputed point that the various interest groups have, in various degrees, been involved in the domestic policy-making in Austria since mid last century. Undoubtedly, organized small– and medium-sized business as represented by the Austrian Federal Economic Chamber (AFEC) and organized labor as represented by the Austrian Trade Union Federation (ATUF) have the most prominent role among the vested interests, not only forming the backbone of what has been termed "social partnership" but also supplying the thinktanks and the "pools of recruitables" the political parties in this country have always been eager to tap whenever vacancies have to be filled. Both pressure groups as organizations are structured highly centralized which explains to some extent the ease with which both organizations have managed to speak with one voice over so many years now. Speaking with one voice has been made possible mainly by the high degree of homogeneity of interests in either group. This has proved key to sustain the high level of political stamina for so long. However, as to the role financial markets are supposed to have in economic life in Austria, the most important single factor has turned out to be the homogeneity of interests not only within either pressure group but also between the both, that is, between AFEC and ATUF.

The huge overlap of interests between the two major interest groups with respect to the shape of the financial system is indeed surprising but only at first glance.

That the ATUF takes sides with a relationship-based financial system thereby defying the supposedly higher allocative powers of financial markets, particularly the stock markets, does not deserve special commentary. To organized labor, financial markets have been the quintessential symbol of brute capitalism ever since capital markets rose to importance. This has not changed with the increasing relevance of financial markets for even blue-collar workers and laborers, the traditional constituency of the unions, to make beyond-social-security provisions for retirement.

That organized business in Austria has been leaning towards relationship-based rather than market-based external financing roots primarily in the specifics of the governance structure of the great majority of Austrian firms. Nearly 95 percent of the Austrian businesses are small– and medium-sized, most of which are run by the owners themselves or by the members of the company-owning family. Only the few larger Austrian companies, mostly former state-owned companies, and the larger Austrian banks and insurance firms are run by managers who may at best be small shareholders of the companies they are in charge.

The corporate control view as outlined above provides a perfectly rational underpinning for the small business owners' dislike of capital markets, particularly of the stock market and for their leaning towards bank lending. Having circumvented the cumbersome and often costly owner-manager-struggle by running the firm by herself the incumbent manager-owner in need of outside funds will tap first those sources which leave her into the driver's seat at the lowest cost. In this context, secured debt is the prime candidate. For the borrowing incumbent manager-owner, secured debt has the advantage over unsecured debt or shares in that collateralized lending induces the lender not too closely dog-watch the borrowers' activities as suggested by the delegated monitoring view of financial intermediation (Diamond, 1984). Hellwig (1998A) quotes a systematic study of Gessner et al. (1978) which states that German banks collect an average of 80 percent of their claims on collateralized loans in bankruptcy compared to only 3 percent on unsecured debt. In talks with Austrian bankers these figures have been confirmed as being authoritative for Austria as well. No wonder that most bank lending to incumbents in Austria is protected through wholesale collateralization, not only freeing Austrian banks largely from the nuisance to keep track of what the borrower is doing but also shielding them effectively from unmitigated disaster in case the counterpart goes under. This is what the incumbent manager-owner who loves to be at the controls likes most. In addition, there is ample evidence even from countries where the "main bank principle" is prevailing that firms are used to maintaining a multiplicity of banking relations just for the purpose of keeping the banks' controlling power as inferior as possible by playing the different banks off against each other in loan negotiations (for Germany, see Harhoff – Körting, 1998). So much to the supposed exchange of control rights for finance.

What incumbent manager-owners do not like are outside shareholders who, knowing that they are easily being played off against other outsiders, have to stay nosy in order to not be led astray (or cheated on). Since shares cannot be secured, they are value at risk per definition, external investors ready to provide funds in form of shares have a far higher incentive to spend resources on

monitoring (and on interfering with the management) than banks with nearly fully secured claims. While knowing for sure that efficaciously monitoring the management of a firm is well beyond their reach rational outside shareholders thus change gears and do what arm's length investors and relationship lenders alike always do when they are getting aware of their little contractual rights and power: they keep their powder dry by trying to keep their claims short and highly profitable. As a result, rational outside shareholders demand a quick and high return of investment and an exit opportunity, that is to say, a liquid stock market to divest in timely fashion.

It goes without saying, that the horizon of the incumbent manager-owner, in general, does not match the short-termism of the rational outside shareholder. Manager-owner usually take a long-term investors' view and consider their doing under the perspective of long-term profitability and sustenance. No doubt, managers driven by such an incentive structure become soon the darling of the banking industry with even the most conservative banker convinced that her claims are safe. No doubt either, even the most patient among the shareholders (with the exception of the really dumb ones) won't dare to let her money go into a business led by a manager with a long-term perspective like that.

If the company is led by an agent manager, however, the management's attitude towards markets as a source of external funding is different, that is, highly favorable. Though the agent manager of a public corporation also prefers retained earning to external funds and is also very likely to suppress outsider control rights she is usually by far less deterred from playing the stock market, by issuing shares, than the owner/manager. The reason for that is that agent managers and stockholders share the preference for short-term profitability. Since the position of an agent manager is less than secure – agent managers can easily be fired and hired – she has a clear incentive to deliver high profits fast, that is, well before her term which is usually short- to medium - term expires. Thus, shareholders and agent managers share the same spirit as to how to run a company. This is what the stock market drives. As put by Hellwig (1998A), a manager who becomes CEO at the age of 50 (or later) and expects to retire at 65 (or earlier) will try to follow strategies that she enjoys while she is there even if they may cause problems for the company thereafter. If a manager becomes CEO at the age of 40 (or sooner) she will behave exactly the same. In order to buttress her career prospects (i. e., becoming CEO of a Blue-chip company) she will push short-term profits at all costs (sometimes, as we learnt recently, even at the cost of cooking the books) to signal to those who make the decisions on CEO succession in other companies how good a leader she really is. The stock market is (ab-)used by these agent managers as a showcase supposed to raise attention of or reconfirm those who have the say as to who gets the lead in a firm. It certainly needs guts to turn an applicant for a top-gun position down with a shiny stock market record in her resume. In this respect, the notion that the stock market's prime function is to work as a "market for corporate control" gets a special meaning, namely that of a market for CEO succession. This is, of course, fully in line with the observation that the agent managers of public corporations were among the first who lobbied for financial market development.

What this story is telling us is the following. Financial markets as the prime source of external funding prevail wherever agent managers, that is, the number of public corporations, reach a "critical mass" to become influential enough to successfully urge "politics" to press ahead with

financial markets reform. Wherever agent managers fail to exceed this limit, as is the case in Austria, politics usually resist lobbying on financial market expansion. In the latter case, relationship-based external funding usually superposes arm's length financing.

Politicians will always join forces with a constituency which they can easily identify. Incumbents such as manager-owners and stakeholders of all kinds tend to be concentrated in certain locations and most importantly tend to vote in well-defined constituencies. Hellwig (1998A, p. 30) is perfectly right in stressing that "outside shareholders in contrast are difficult to identify and to see as actual people. They tend to be dispersed. Their identities and locations change with every stock market transaction". In addition, outside shareholders often lack the ability to rally to the extent that their voice is heard and followed in political and judicial controversy. As a result, politicians tend to align with stakeholders and insiders rather than stockholders and outsiders. This is exactly what has happened in Austria since WW II. The privatization of state-owned companies and a "pro-stock market-media-hype" in the nineties of the previous century has changed little in this picture as the figures show. There is, however, one strong point speaking strongly for an increasing political support of financial market development in the near future which has already gained momentum in Austria as in almost all advanced economies in Western Europe: this is "aging population". The increasing number of claimants for a social security pension will keep overstraining the governments' budgets to a point where a new generation of politicians is altogether deprived of making a difference. By partly privatizing the pension system through subsidizing individuals in case they play the stock market for the purpose of privately providing for retirement the "nowaday politicians" believe to have found the recipe to keep the elderly from consuming an ever increasing portion of the value-added generated by the young for good.

## 3.2 The Role of Banks and Markets As Seen from the Control View – A Note

In a seminal paper Diamond (1984) proposes that in the setting of asymmetric information financial intermediaries such as banks have a comparative advantage in monitoring the borrowers' activities. Banks avoid the duplication of effort of the monitoring of borrowers by small investors and this allows banks to deliver delegated monitoring. As mentioned above, the delegated monitoring view of banking does not do a good job to explain the lending behavior of Austrian banks. The Austrian evidence suggests that banks rather have a comparative advantage in effectively securing claims. In the control view this is the banks' key contribution to improve overall efficiency. Whereas monitoring activities can very well be performed by specialized firms such as rating agencies and auditors safeguarding the claims of the great many small depositors on the great many borrowers takes the expertise and the powers of bankers. In a context like that effectively collateralizing the claims is much less costly than monitoring the borrowers.

Shares are risky business and they cannot be secured, for sure. Thus, rational (or professional) shareholders best safeguard their claims by, while keep staying in the market, following a short-term buy-and-sell rather than a long-term buy-and-hold strategy. According to the control view of corporate governance, this is the most effective way for shareholders to get away without being duped by the incumbent agent managers. Outguessing other players in the market may pay, outguessing the management of a company whose stocks one holds seldom does. Needless to say

that this view, while having much in common with the writings of financial economists promoting the behavioral finance view such as Shiller (2000) and Shleifer (2000), is not at all liked by influential advocates of long-term stock holding such as Siegel (1994).

## 4. The Insider-Principle and the Financing of Structural Change

The question still remains to be answered how efficient the allocation of funds can possibly be when the incumbent management has full discretion over the use of free cash flow and outsiders providing external funds are virtually without influence on the choices taken by the management. In mature economies such as Austria and other OECD countries, the attention focuses on the fact that a system which is heavily biased towards internal finance may run an extra-high risk to generate both overinvestment and underinvestment. This point is addressed in Hellwig (1998A, p. 21) as follows: "For mature economies, the availability of finance for structural change may be more important than the behavior of aggregates. An analysis that focuses on aggregates neglects the role of structural change in the economy. Different firms and different sectors have different cash flows and different investment opportunities. In the cross-section of firms in the economy, cash flows and investment opportunities are not always correlated. This raises the possibility that one may have overinvestment and underinvestment phenomena at the same time, overinvestment phenomena at mature firms milking their cash cow, underinvestment phenomena at new firms that do not yet have enough profits from sales of established products to finance their development activities. The two effects, overinvestment at old firms and underinvestment at new firms, are then but two sides of the same coin, namely the imperfect correlation of cash flows and investment opportunities across firms". According to Hellwig (1998A), there is not much of a distortion in the allocation of funds if current profits also indicates further investment needs. This may have been the case in Germany and Austria during the fifties and sixties of the last century as capital was scarce altogether and reliance on internal funds by promoting retained earnings and accelerated depreciation with significant tax subsidies was almost a sure guess. The allocation problem raised by Hellwig occurs when cash flow availability is not a good indicator for capital scarcity. Hellwig (1998A) argues that this does not mean that a system based on internal finance necessarily heads for trouble by impairing structural change. If the financial system is designed set to channel funds from firms with excessive cash flow to firms with insufficient funds rather than funnel funds from households to firms the allocative deficiency of a cash flow-driven financial system can be overcome.

As pointed out above, there hardly is an advanced economy where firms depend more on the availability of internal funds than in Austria. Has this been to the disadvantage of economic growth and public welfare in Austria so far? Right now, nobody knows for sure. The corporate control view as outlined here suggests that given an open, competitive environment the incentive structure for keeping development activities going is under no other governance as clear-cut as under the reign of long-term oriented manager-owners. When a manager-owner fails in a system which is not only competitive but also relying heavily on internal financial markets she looses not only the basis for earning her bread but also reputation and esteem with little prospects of getting a second chance to start over again. In this context retention used to build reserves is key to survive during times

which may fall hard on the company. In addition, casual observation indicates that Austrian banks have the lead in venture-capital-financing new firms by encouraging mature firms rich in free cash flow but poor in new investment projects to provide funds in the form of equity lending. This does some to compensate for the underdevelopment of the stock market which is given not much credit in terms of facilitating genuine structural change anyhow.

## 5. Concluding Remarks

This paper has been aimed at explaining why Austria has developed a financial system which is that much relationship-based and that little market-based. In so doing we apply the control view of corporate governance as outlined by Hellwig (1998A). This view states that the managements' or incumbents' powers to disenfranchise all kinds of outsiders be they outside stakeholders such as banks or outside shareholders is key to understand the structure of financial systems. In all governance systems there seems to be a vital interest of the incumbent management, or insiders, to immunize themselves against interference from outsiders. Since outsiders such as outside shareholders often lack the ability to rally to the extent that their voice is heard and followed in political and judicial controversy politicians tend to align with stakeholders and insiders rather than stockholders and outsiders. This is exactly what has happened in Austria since WW II. The privatization of state-owned companies and a "pro-stock market-media-hype" in the nineties of the previous century has changed little in this picture as the data show.

This paper also states that financial markets as the prime source of external funding prevail wherever agent managers, that is, the number of public corporations, reach a "critical mass" to become influential enough to successfully urge "politics" to press ahead with financial markets reform. Wherever agent managers fail to exceed this limit, as is the case in Austria, politics usually resist lobbying on financial market expansion. In the latter case, relationship-based external funding usually superposes arm's length financing.

This paper further identifies the overlap of interests between the two major interest groups, organized small– and medium-sized business and organized labor, as the most important factor that has shaped the financial system in Austria since WW II. Organized business' leaning towards relationship-based rather than market-based external financing roots primarily in the specifics of the governance structure of the great majority of Austrian firms. Nearly 95 percent of the Austrian businesses are small- and medium-sized, most of which are run by the owners themselves or by the members of the company-owning family. Only the few larger Austrian companies, mostly former state-owned companies, and the larger Austrian banks and insurance firms are run by managers who may at best be small shareholders of the companies they are in charge. The corporate control view as outlined in this paper provides a perfectly rational underpinning for the small business owners' dislike of capital markets, particularly of the stock market and for their leaning towards bank lending. Having circumvented the cumbersome and often costly owner-manager-struggle by running the firm by herself the incumbent manager-owner in need of outside funds will tap first those sources which leave her into the driver's seat at the lowest cost. In this context, secured debt is the prime candidate. For the borrowing incumbent manager-owner, secured debt has the

advantage over unsecured debt (i. e., bonds) or shares in that collateralized lending induces the lender not too closely dog-watch the borrowers' activities.

The efficiency of a financial system which is based on retention and secured debt is not clear yet. The paper conjectures that the incentive structure which drives a long-term oriented manager-owner is among the strongest in terms of fostering structural change. Given an open and competitive environment a manager-owner has to keep development activities going because failing means not only loosing a job but also quite frequently being put out of the running for good.

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