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► **To cite this version:**

Bernardo Melo Pimentel, Guillermo Hunter Ramírez. Dauids and Goliaths: Hidden champions in an age of state capitalism. 2022. hal-03685959v3

HAL Id: hal-03685959

<https://hal.science/hal-03685959v3>

Preprint submitted on 26 Aug 2022

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B. Business Impact

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ESCP Impact Paper No. 2022-04-EN

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Abstract

We review the state of the current industrial champions debate and make the case for small, nimble Davids, rather than resource-hungry Goliaths. These export-based SMEs have shown robust performance in recent years and may help economies increase their resilience in times of significant uncertainty. They are more autonomous than traditional champions and they are already in our midst. The challenge for policymakers is how to foster an environment that supports Davids while keeping an eye on national strategic interests.

Mots clés (keywords): Industrial policy; National champions; hidden champions

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Dauids and Goliaths: Hidden champions in an age of state capitalism

This last January, in his address to the European Parliament, President Macron reiterated the urgency to create and stimulate 'European champions'. With the prospect of the Russian invasion of Ukraine looming on the horizon, Mr. Macron emphasized the need to invest more in the defence sector champions, as a means to "remain open without being dependent". While recent, the content of the speech was neither surprising nor novel. Just two years prior – in the aftermath of the European Commission's block of the rail merger between Siemens and Alstom – a similar push had been made. In a joint communication with the German Chancellor, the two leaders urged the European Commission to prioritize strategic interest over antitrust policy. In chancellor Merkel's words, Europe should follow the lead of countries such as the United States, South Korea, Japan, or China. In short, the EU "must not be afraid to have global champions, but we must work towards them".

Typified in the two examples above is the growing political will to foster the development of large national or regional, state-sanctioned conglomerates. These 'Goliaths', are colloquially known as champions and come in different guises. Broadly speaking, they can be defined as individual companies – or a set of oligopolistic firms – that add the strategic national interest to their more common value-maximizing mandate. Champions are either directly established by governments – as a form of state capitalism – or are private organizations that directly or indirectly benefit from preferential treatment by public authorities. Traditionally, champions operate within strategically sensitive, or critical industries, such as defence, commodities, or non-tradeable essential goods. They also tend to have a strong prevalence in natural monopolies – sectors where the significant weight of fixed costs requires few, large scale operators to attain competitiveness. These include utilities such as water, gas, or electricity, and infrastructure, ranging from the road and rail network to wireless telecommunications.

The case for champions

In principle, there are many arguments to be made for the strategic and economic advantages of industrial champions. In critical sectors, they act as gatekeepers for national or block interests. The previously mentioned EU defence argument used in President Macron's speech is an example of this line of reasoning. There are, however, other instances in which this argument has been employed. During the rollout of the 5G wireless network throughout Europe in 2019, strong political pressure from national governments and multilateral organizations (notably NATO) alike was put in favour of a European, rather than a Chinese backend operator (Friis & Lysne, 2021). The prospect that countries like the Czech Republic would have Huawei – a Chinese telecommunications company – rather than Ericsson – a Swedish telecom – as a provider in their networks generated a strong political backlash. While not explicitly a matter of territorial defence, the issue was categorized as one of national security, in which non-intervention could lead to "possible loss or interruption of availability, integrity or confidentiality in such systems" (Kaska, Beckvard, & Minárik, 2019).

A second, and increasingly popular, argument for the support of champions is that of supply chain resilience. The ongoing pandemic and its lockdowns as well as the invasion of Ukraine have led to growing calls for 'onshoring' or 'reshoring' production. The aim of such policies would be to mitigate the effects of price surges, shortages, and delivery fulfilments in a wide range of raw materials, intermediate components, and final goods (Kammer, Azour, Selassie,

Goldfajn, & Rhee, 2022; Nikolopoulos, Punia, Schäfers, Tsinopoulos, & Vasilakis, 2021). This is, however, a multi-layered problem. Despite talk of ‘slowbalization’ and even deglobalization, the ever-increasing sophistication of consumer and business goods has made us heavily dependent on close-knit networks of highly skilled, specialist suppliers. Required resources and competencies in a complex production process make it virtually impossible for any given country to be able to be fully self-reliant. Additionally, the matter of raw material scarcity still plays a vital role. Responses such as former USA’s president Trump’s bilateralism or its more recent incarnation in the form of ‘friend-shoring’ or ‘ally-shoring’ demonstrate the implicit acknowledgement that even with active industrial policy, economic autonomy may remain a mirage for the foreseeable future.

The third set of viewpoints defending champions can be summarized as them bringing in a number of positive externalities. Large domestic groups frequently develop their own resources and knowledge base in-house. Theoretical support for this view can be grounded on Michael Porter’s notion of clusters and industrial districts – geographic concentrations of companies and institutions of a particular field (Porter, 1998). Clusters use their local knowledge, relationships, and motivation to achieve a competitive advantage. In addition, clusters generate spill over effects and positive externalities in terms of employment, taxation, and support industries (Delgado, Porter, & Stern, 2014). Finally, the climate agenda and the control over emissions have also been pointed out as a reason for taking up industrial action at home (Rodrik, 2014).

But do we need champions?

Listing the pros of champions is naturally only one side of the story, with a long and rich tradition in economic literature. Perhaps the single greatest concern with the promotion of industrial champions is the increase in the market concentration it generates – and the subsequent reduction of competition and rise in prices it produces. Firms are only too aware of the effect that reduced competition has on their market power and often lobby for such policy outcomes. Unsurprisingly, the link between active industrial policy and political corruption has been verified in multiple instances and across contexts, syphoning public resources and eroding trust in institutions (Ades & Tella, 1997; Bahoo, Alon, & Floreani, 2021).

On the other hand, evidence in support of the level of innovations brought up by state-sponsored industrial champions is, at best, lacklustre. The issue seems to be not so much the difficulty in spawning innovations, but their adoption and distribution (Geroski, 1992). Here too, the monopolistic framework of analysis may be of use. Larger firms with a dominant position in the market will have little incentive to perform the necessary investments required to implement new innovations. At the core we have a type of agency problem: public officials are interested and will promote research and development at national champions while decision-makers at the firm level may be reluctant in facing the costs associated with operationalizing their own innovations (Musacchio, Lazzarini, & Aguilera, 2015).

Competition and anti-trust authorities also have it tough: being specifically mandated with targeting excessive market concentration, how should they act when politicians ask for the opposite? Greater market share does contribute to market power and potential for abuse of dominant position by monopolistic players. That this may be a known – or even acceptable – risk has been acknowledged explicitly by politicians. In the speech from the opening example, President Macron expressed that competition law has perhaps been too focused solely on the

consumer and not enough on defending European champions. But can this be a false trade-off?

The future is already here

Unlike many economic models, not everything else was held *caeteris paribus* as the debate on the merits and risks of promoting industrial champions unfolded. A strand of literature – mostly studying the export performance of German companies – has identified a set of relatively low-profile, high-performance firms, the aptly named ‘hidden champions’. Initially coined by Hermann Simon, hidden champions can be defined as midsize, highly specialized export leaders, taking up a top three global market share position – or number one in the company’s home continent (Simon, 1990). They “spearhead” their respective markets via differentiation – rather than cost leadership. They are also highly specialized, which enables hidden champions with economies of scale in single product markets. Thirdly, they operate in highly complex, path-dependent, manufacturing industries, prone to the creation of lock-in effects by their customers (Simon, 2009).

At first glance, our ‘Davids’ differ significantly from their older and larger siblings; they are not household names, ostensibly lacking the ‘national interest’ mandate, and are not started by governmental decree. Their origins lie not in strategically ‘sensitive’ industries, but rather in knowledge-intensive, niche sectors, that enable these champions to establish long-term relationships with their customers (Audretsch, Lehmann, & Schenkenhofer, 2018). And while they compete in global markets, they do so not by virtue of their size, but rather by virtue of their superior export performance.

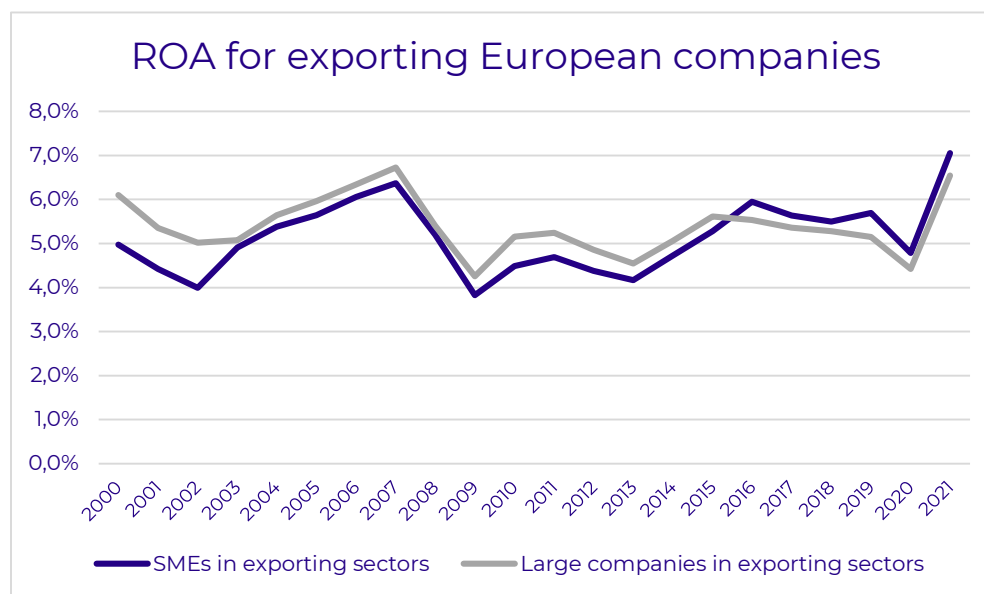


Figure 1: ROA of exporting SME and large companies.
Source: BACH European sample.

Figure 1 depicts the 2000-2021 series on the return on assets (ROA) for the BACH sample of 11 EU countries. The information pictured directly compares the performance of small and medium-sized exporting enterprises (SMEs) with large companies (of an annual turnover greater than EUR. 50 million). While the comparison is merely exploratory and differences between sampled firms are modest, an observable switch in trend over the period of the

analysis is present. Up until 2015, larger companies outperform SMEs. Afterwards, it is the SMEs that lead.

It may be premature to attribute the performance improvement of SMEs to the rise of hidden champions alone. However, it would be interesting to dive into some of the underlying factors that contribute to the explanation of their success. A recent review identified the quality of human capital (particularly at the managerial level), innovation in form of patented proprietary technologies, and nimbleness (a combination of flat organization structure with relatively small size) as the most distinct resources controlled by hidden champions (Schenkenhofer, 2022). Technological developments also play a role; recent experimental research has shown additive manufacturing techniques, such as 3D printing, to significantly reduce the levels of output required to access the full extent of economies of scale (Baumers & Holweg, 2019). This de facto mitigates the size advantage of larger operators and may in the future dilute the power of some industrial champions operating in natural monopolies.

The role policymakers

Policymakers can play a constructive role as well, as many of the arguments often touted to support 'Goliaths', can also be used for 'Davids' – with fewer negative externalities. If the goal is to increase autonomy and shorten supply chains, the hidden champions can chip in. If export competitiveness is the main concern, hidden champions have proved they can lead. In short, hidden champions have demonstrated that SMEs can be leaders in international competitiveness and innovation. The question then is how to create these conditions and foster the success of these new champions.

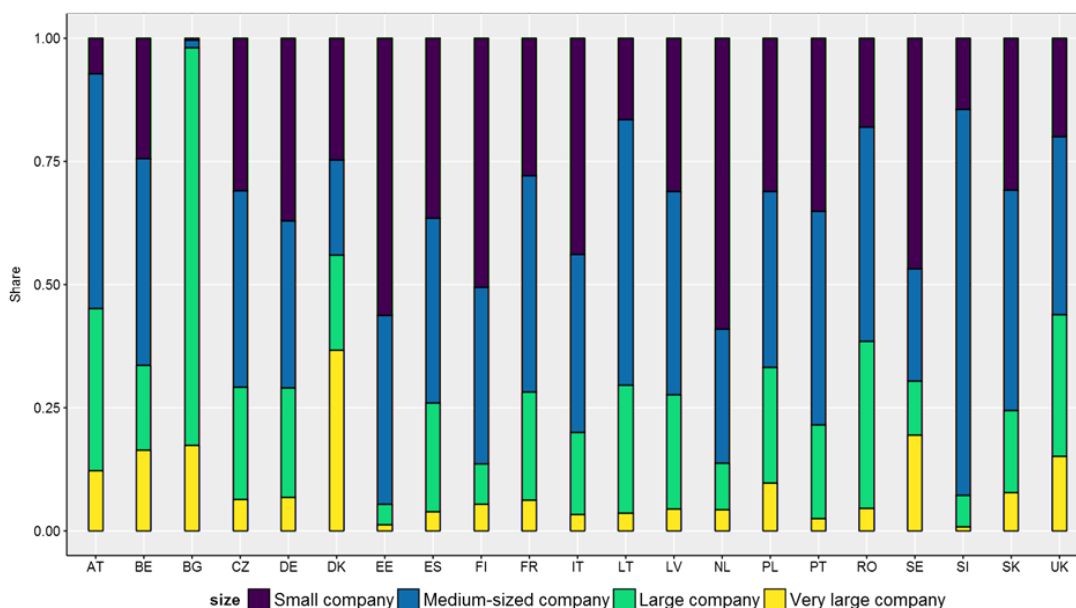


Figure 2: Distribution of total values by country and firm size (2007 - 2013).
Sources: OECD and ORBIS.

In a way, the aforementioned question has already been acknowledged and is being actively tackled with both domestic- and European-wide policies (Bachtrögler & Hammer, 2018). Figure 2 depicts the distribution of EU funds – encompassing structural funds, financial instruments (e.g. the SME instrument), thematic funds, and internationalization support – per member state and firm size¹ during the 2007 - 2013 period. A quick glance at the distribution of funds confirms that – with the exceptions of Bulgaria and Denmark – SMEs are already the biggest group of beneficiaries. Medium-size companies, the most likely ‘Davids’, make up a respectable share of funding in most member states, corresponding to roughly half the sharing of support in Austria, Lithuania, and Slovakia. In profile, support recipients exhibit many value creating, desirable traits; they are more likely to be in high-tech sectors, already have a track record of previous venture capital funding and demonstrate high-growth potential (Mina, Di Minin, Martelli, Testa, & Santoleri, 2021).

It is also relevant to look at the pool of applicants, not only recipients. Here, we observe that a very significant portion corresponds to younger firms still facing financing constraints. This should be regarded as an opportunity and call for action. Rather than seeking existing ‘Goliaths’, legislators should be concerned in identifying future ‘Davids’.

The new ‘NextGenerationEU’ stimulus package provides a rare opportunity for shaping the future for European wide manufacturing. The ‘InvestEU’ fund in particular – itself encompassing thirteen centrally managed EU financial instruments - has an explicit mandate for the support of SMEs. With an endowment of EUR. 10.28 billion controlled by the European Investment Bank, the fund is tasked with investing in the innovation, digitalization, sustainability, and green transition of small and medium-sized enterprises and mid-caps. However, its policy goals also mentioned the support of public ‘strategic investments’ that support the ‘common European interest’. Excessive reliance on these projects will inevitably crowd-out private investment and reduce resources available for SMEs. For policymakers, the hard challenge is then to understand what ‘common interest’ genuinely means.

Conclusion

In the present piece, we reviewed the current state of the industrial champions debate, recentring the discussion on the rising phenomenon of hidden champions. The present climate of high uncertainty has sparked renewed calls for state intervention in sectors of the economy deemed sensitive for geopolitical and strategic reasons. The promotion of large industrial champions that can safeguard national interests and withstand future shocks has been a frequently voiced argument by policy makers. However, this option has in the past come at the expense of direct public funding, indirect preferential treatment, and increased industrial concentration – with all its implication in terms of higher prices and reduced innovation.

We instead made the case for the new ‘Davids’, the hidden champions. These export-based SMEs have shown robust performance in recent years and may help economies increase their resilience in times of significant instability. They are more autonomous than traditional champions and evidence shows they may be outperforming them. Rather than lobbying for state interventionism or for the scrapping of anti-trust mandates, hidden champions welcome global competition. They rely on high-quality human capital, patent portfolios, organizational

¹ ORBIS firm size categories: Very large companies: 1,000 or more employees; large companies: 150 or more employees; medium-sized company: 15 or more employees; small company: all others.

nimbleness, and incisive usage of novel technologies like 3D printing to compete in global markets.

The benefits of supporting hidden champions appear to be evident, but the cost of perceived inaction for policymakers is often too high; the devil will find work for idle hands to do. This is only amplified by the unique opportunities that the 'NextGenerationEU' will bring. The pathway then must start by accepting that it is the 'Davids' and not the 'Goliaths' who are in fact the best paladins of national interests. It may be time for the hidden champions to come out and take their place in the limelight.

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