

Chapter 7

Enterprise Models: Freestanding Firms versus Family Pyramids

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1. Introduction¹

Business enterprises are organized very differently in different countries, and neoclassical economics is built around only one such model. Limited liability firewalls, limited partnerships, and other such legal niceties aside, “firm” and “corporation” are approximately synonymous in modern America and Britain; and whole fields of “corporate” finance, “corporate” governance and “corporate” strategy model decision-making at the level of the corporations. However, this synonymy is both historically recent and geographically exceptional, leaving these major branches of economics oddly disconnected in other countries and historical eras.

Big business in many countries is organized as business groups (La Porta et al. 1999): constellations of seemingly distinct separately listed corporations, each with its own CEO, board of directors, creditors, and public shareholders, but all controlled by a single decision maker, usually a wealthy old-moneyed business family, less commonly a single powerful tycoon. For simplicity, we define a “business group” as two or more listed firms under common control.² The largest business groups in some countries encompass dozens, or even hundreds, of distinct listed and unlisted firms, and comprise sizable fractions of national economies. Their ubiquity in today’s successfully emerging markets and their historical prominence in late industrializers’ peak growth periods suggest that business groups are far more than chance configurations. They may well play a pivotal role, for good or ill, in deciding the wealth of nations.

2. Business Group Basics

Both historically and across modern economies, business groups are usually organized as pyramids (La Porta et al. 1999). A family firm controls a first tier of listed companies by holding a dominant equity block in each. A majority block in each is often unnecessary, as small shareholders seldom vote in annual general meetings; however control can be assured by allocating multiple votes to each share held by the family firm, by reserving a majority of seats on the board for family representatives, or by allocating enough shares to family controlled financial institutions – mutual funds, pension funds, and the like – to raise the family’s total voting power above fifty percent.

Through like mechanisms, each first tier firm, in turn, controls several listed firms in the pyramid’s second tier, and each of these, in turn, controls yet more listed firms in a third tier. The pattern can be replicated through as many tiers as are needed to leverage the family’s private wealth into control over a business empire containing corporate assets worth vastly more. The strategic insertion of unlisted firms throughout the structure can help disguise the actual chains of control. Thus, although hundreds of firms might trade on a country’s stock exchanges, most might belong to ten, five, or even one huge pyramidal business group. A facade of pluralism and competition can thus disguise a monolithic concentration of corporate control.

The control leverage equity financed pyramiding provides can be startling (Morck, Wolfenzon and Yeung 2005). For example, Hogfeldt (2005) finds Sweden’s two largest pyramidal groups, together, controlled firms comprising 63% the total value of all listed Swedish firms in 1997. The largest of these,

¹ This chapter draws heavily from Morck, Stangeland and Yeung (2000); Morck (2005, 2009, 2011); Morck and Yeung (2004, 2007); and Morck, Wolfenzon, and Yeung (2005). To avoid clutter, we do not cite these articles each time we draw from them. However, ambient cites to these works prevail throughout the entire chapter.

² This definition, introduced by La Porta et al. (1999), is now standard in the finance literature. Other definitions stretch business groups to include Japan’s keiretsu groups, connected by networks of small intercorporate equity stakes, and even firms connected by their CEOs networks of friends and acquaintances (Khanna and Yafeh 2007). While each definition has its merits, ours is uniquely useful in the present context.

containing a who's who of major Swedish firms – Ericsson, ABB, Saab and many others – that together summed to roughly 40% of the country's roughly one half trillion US dollar total stock market capitalization, was controlled by the Wallenberg family with a roughly US\$2.2 billion stake of super-voting shares in Investor, the apex firm, consisting of a 0.5% direct stake and a 22% stake held through a trust. This hundredfold multiplication of wealth into control is accomplished with a multi-tiered pyramid held together with super-voting shares. For example, until 2006, the group's control block in Ericsson consisted of a small block of super-voting shares, each with 1,000 times the voting power of ordinary shares.³ A pyramidal business group controlled by one branch of Canada's Bronfman family in the 1990s contained sixteen tiers and over five hundred corporations, listed and unlisted, again with relatively modest family wealth sufficient to control the structure's apex sufficing to lock in control over the whole structure.⁴ Another group, controlled by the Naboja family accounted for some 40% of Ecuador's exports and allegedly provided the incomes some three million of the country's eight million people.⁵ Li Ka-shing, Asia's richest man, controls a vast business group that not only dominates the economy of Hong Kong, but encompasses a huge array of operating companies around the world. Throughout Europe, Latin America and Asia, a handful of such structures constitute the greater part of each nation's private big business sector.⁶

3. History Lessons

Business groups figure prominently in economic history, especially in late industrializers. America's post-Civil War industrialization, especially its era of most rapid development around the turn of the 20th century, occurred largely under the auspices of its Robber Barons – tycoons, such as John D. Rockefeller and John Pierpont Morgan, whose business empires each included numerous distinct companies.⁷ At the height of Canada's industrialization, the so-called Laurier boom surrounding the turn of the 20th century, over forty percent of the assets of the county's hundred largest businesses were held within

³ The Wallenberg empire shrunk somewhat after 2000 (Henrekson and Jakobsson 2011).

⁴ Morck, Stangeland and Yeung (2000).

⁵ See De Cordoba, Jose. 1995. Heirs battle over empire in Ecuador. Wall Street Journal (electronic ed.) Dec. 20.

⁶ Similar pyramidal groups, usually controlled by business families, predominate in the economies of Argentina (Fracchia, Mesquita and Quiroga 2010), Brazil (Aldrichi and Postali 2010), Chile (Khanna and Palepu 2000); Colombia (Trujillo et al. 2012); East Asia in general (Claesens et al. 2002); Lefort 2010), India (Khana and Palepu 2005; Sarkar 2010), Israel (Kosenko and Yafeh 2010; Kosenko 2012); Italy (Aganin and Volpin 2005), Mexico (La Porta and López-de-Silanes 1999; Hoshino 2010); Russia (Gurieyev 2010), Pakistan (Mahfuzul and Kabir 2001); Singapore (Tsui-Auch and Yoshikawa 2010), South Africa (Goldstein 2010), South Korea (Bae et al. 2002; Kim 2010), Taiwan (Chung and Mahmood 2010), Thailand (Charumilind, Kali and Wiwattankantang 2006; Suehiro and Wailerdsak 2010), Turkey (Colpan 2010); Western Europe in general (Barca and Becht 2001; Faccio and Lang 2002); and the global economy in general (La Porta et al. 1999; Masulis et al. 2011).

⁷ America's late 19th and early 20th century business groups were structured as voting trusts: a unique organizational form necessitated by legal restrictions proscribing corporations from owing shares in corporations located in other states (Becht and De Long 2005). This makes American business history less generally useful as a background against which to study other countries in this specific context. This chapter consequently draws heavily on Canadian examples on the grounds that Canada is similar to the United States in many ways, but exhibits more typical business groups throughout its history as an industrializing and industrialized economy (Morck, Percy, Tianb and Yeung 2005). We beg the indulgence of American readers, who might reasonably expect more examples from their country's history. The political economy forces that caused American states to establish and retain these restrictions, until New Jersey broke ranks near the turn of the 20th century, are incompletely understood (Becht and De Long 2005).

twelve pyramidal groups (Tian 2006). Japan's high growth period, from the 1880s through its successful industrialization by 1920s, saw its economy almost entirely organized into pyramidal business groups, called *zaibatsu* (Shiba 1997). Similar structures, called *chaebol*, dominated South Korea as it developed rapidly in the 1970s and especially the 1980s (Bae et al. 2002). Large, initially predominantly equity-financed pyramidal business groups also play important roles in the industrialization eras of Germany (Fohlin 2007, Italy (Aganin and Volpin 2005), Sweden (Högfeldt 2005), and other European countries; and played a role in American (Berle and Means 1932) and British (Jones 2000) economic development too.

This pattern suggests that such groups might have features that are especially useful during very rapid industrialization, and might constitute optimal second best solutions amid incomplete markets and imperfect institutions. But the prevalence of similar groups in Latin America, South Asia, and other regions that have long failed to attain first world status (Colpan et al. 2010) – the Brazilian adage “This is, and always will be, the country of the future” comes to mind – also suggests that they sometimes become a hindrance, or even an explicit liability, in later stages.

3.1 Business Groups in Japan's Industrialization

Japan, an industrial power by the 1920s, was the first non-Western country to industrialize successfully.⁸ Admiral Perry's mid-19th century gunboat diplomacy abruptly ended Japan's hermetic isolation, and exposed its relative impotence and poverty. Concluding that foreigners could only be beaten back with foreign technology, they sent the cream of Japanese youth abroad for education and reconnaissance, and grew more dismayed as Japan's true situation grew clearer. Resolved to jumpstart industrialization, Japan's government hired foreign experts and returning students to establish new state-owned enterprises (SOEs) in each sector deemed essential to modernization in the 1870s. These soon bled money rapidly, triggering a budget crisis and collapsing both the yen and Japan's credit in London. A liberal government took over, organizing the world's first mass privatization in the 1880s to sell off virtually all the SOEs. Thus stung, Japan embraced a classical liberal vision of government until the 1930s military takeover.

The mass privatization ultimately transferred most former SOEs to wealthy merchant families, and a high growth era commenced. The families rapidly assembled large pyramidal business groups as a growing middle class took to investing in shares. The business groups diversified widely, the largest each controlling a firm in virtually every industry. Pyramid members produced inputs for other member firms, bought each other's outputs, made complementary goods to each other's products. By the 1920s, the industrial structure of Japan's economy resembled those of other developed countries. While historians of the Japanese economy debate the ethics of the *zaibatsu* families, especially amid the military takeover in the 1940s and the ensuing war, the overwhelming predominance of a few very large family-controlled pyramidal groups over the country's economy during its rapid industrialization is uncontroversial.⁹

3.2 Business Groups in Late Industrializers

Variously called business groups, pyramids, *zaibatsu*, *chaebol*, robber baronies, and terms yet less flattering, structures akin to *zaibatsu* loom large in the economic histories of many countries. The

⁸ This section is a vastly simplified synopsis of Morck and Nakamura (2005, 2007).

⁹ The chapter by Bruland and Mowery in this volume discuss the role of the *zaibatsu* in product and process quality improvement, and their ties to the education system.

structures generally appear as financial markets develop sufficiently to let their controlling shareholders leverage their wealth with public investors' money, though not always.

The first developed economies – Britain, Flanders, the Netherlands, and perhaps a few others – apparently managed without large pyramidal groups; though more detailed examination of shareholder records may yet challenge this. But these countries were beating paths through the wilderness, and took centuries to do what Japan did in decades. As noted above, other successful late industrializers – Canada, Germany, South Korea, Sweden, etc. – all developed large pyramidal groups very similar to Japan's zaibatsu in structure, scope, and scale. America's robber barons used trusts to control their vast business groups in the late 19th and early 20th centuries, only switching to pyramiding after antitrust laws and other developments shifted the legal landscape (Becht and De Long 2005; Bonbright and Means 1932), rendering trusts inoperative and pyramiding viable.¹⁰ Despite these differences, some evidence suggests American business group firms were also star performers in this era (De Long 1991). Countries now associated with bank-based financial systems, such as Germany (Fohlin 2005) and Japan (Morck and Nakamura 2005), all relied primarily on stock markets to capitalize large business groups in the 19th and early 20th centuries; and only shifted towards bank financing after their industrializations were complete.

A second common feature of large business groups is their sweeping industrial diversification (Khana and Yafeh 2007). For example, Canada's largest late 19th century pyramidal business group, run by Max Aitkin, a.k.a. Lord Beaverbrook, spanned the full array of modern industries – from steel to cement to insurance; and the others were scarcely less diversified (Morck, Percy, Tian and Yeung 2005). These groups were not restricted to manufacturing, but encompassed all manner of service, trade, and even agriculture-related firms. The Beaverbrook Group and others like it transformed the country, still largely agrarian in the early 1890s, into a predominantly industrial economy by the Great War. A second wave of pyramiding in the 1920s capitalized lighter industries – automobiles, electrification, power and water, traction, and the like. Large business groups in nouveaux riches Asian economies are also supremely diversified, as are their likenesses in the still emerging economies of Israel, Turkey, South Asia, and Latin America. Khana and Yafeh (2007) show pyramidal groups in today's developing economies to be diversified extraordinarily widely – the largest having member firms in virtually every sector.

A third common feature of large pyramidal business groups is their tight connections to government. Japan's prewar parliament featured a major party associated with each of its largest pyramidal business groups. In Canada, Arthur Meighen, the controlling shareholder of Canada General Investment, the country's largest pyramidal group in the 1920s, twice served as Prime Minister in that decade. Sweden's largest pyramidal business groups, especially the largest, controlled by the Wallenberg family, developed tight links with the country's Social Democratic party by simplifying tripartite agreements. A simple conversation between the Prime Minister, a national union leader, and a few business family patriarchs could produce an accord on industrial subsidies, labour peace, entry, taxes, and tariffs (Högfeldt 2005).

Another intermittent theme is an inflow of foreign capital. Lord Beaverbrook's lower tier firms were usually cross-listed in London, whose financial markets were by then accustomed to financing national development schemes organized as pyramidal business groups; and during Canada's high growth period – roughly 1896 to 1913 – more British capital flowed into Canada than into any other

¹⁰ See footnote 4 above re. trusts. Becht and De Long (2005) describe these legal changes in detail. In brief, criticism of trusts for organizing monopolies gave rise to anti-monopolies laws aimed specifically at trusts. Business lobbying induced New Jersey to amend its laws to allow pyramiding as a substitute mechanism with which a single tycoon or business family might control a large number of seemingly distinct firms.

country. Nonetheless, other pyramidal business groups, usually headquartered in Britain and with member companies' shares trading largely in London, but with their operating companies physically located in far flung corners of the 19th and early 20th century British Empire, undertook to develop the economies of Australia, Britain's Chinese concessions, Hong Kong, India, and the British West Indies (Jones 2000; Allen this volume). Similar groups operated constellations of businesses outside the Empire – most notably in Argentina.

3.3 Business Groups in Perpetually Developing Economies

Many Latin American countries seemed ready for economic takeoff in the late 19th century, and again in the 1920s, and again in the 1960s, and seem similarly poised today. India seemed ready for takeoff through the 1950s, and then stagnated for decades. Egypt, Indonesia, the Philippines, Turkey, and numerous other middle-income countries, likewise cleared for takeoff by investors, development economists, and the business press, returned to their terminals.

Firms affiliated with business groups in poor economies tend to be their star performers (Khanna and Yafeh 2007). In successfully developed economies, this finding is typically reversed (Morck, Wolfenzon and Yeung 2005). The former result invites several explanations, which leads into explanations for the latter result that are detailed in the next section.

Why should business group firms be star performers in low income economies? Low-income economies typically have weak institutions. High transactions costs constipate their labour, capital, and product markets. Corruption undermines the rule of law and the viability of business contracts. Weak investor protection undermines trust in financial markets and institutions. Business groups may well be second best solutions to these problems. Absent good institutions, member firms in business groups can reduce transactions costs by hiring personnel from each other, investing in each other, and doing business with each other. A common ultimate controlling shareholder prevents group firms from cheating each other, and a family's good name can engender trust among outside investors, customers, and suppliers. This credibility can also commend family group member firms to state-owned enterprises, or government agencies, and banks that would otherwise risk large non-performance costs. Large family-controlled business groups may well possess a genuine economic advantage over freestanding professionally run firms in such economies.¹¹

4. A Rite of Passage?

These considerations suggest that large pyramidal business groups might enhance efficiency – at least under some conditions and in some phases of economic development. An era of oligarchs, robber barons, and the like might even be a rite of passage into the ranks of high income countries.

4.1 Insiders and Outsiders

The historical importance of business groups confounds students of corporate governance, who associate pyramiding with aggravated agency problems (Berle and Means 1932; Bebchuk, Kraaakman and Triantis 2000). Microeconomics associates efficient resource allocation with firms maximizing their

¹¹ Empirical evidence pertinent to these points is primarily from present day economies (Leff 1978; Khanna and Palepu 2000; Khanna and Fisman 2004; Khanna and Yafeh 2007). More specifically, Khanna and Palepu (2005) present evidence that firms in a major Indian business group, that controlled by the Tata family, have a major advantage over independent firms in innovation and Morck, Stangeland and Yeung estimate Canadian business group member firms' costs of capital to be lower than those of their independent peers.

value, specifically the expected present value of their future profits. But firms are run by utility maximizing top executives. Agency problems arise where these top executives, who are supposed to be faithful agents acting for the firm's owners, its shareholders, instead maximize their own utility (Jensen and Meckling 1976). Agency problems are shown by a broad empirical literature to exert a first order effect on returns to capital, and agency cost minimization is thought to drive mergers, divestitures, and business organization in general (Shleifer and Vishny 1997).¹² Given this, the historical ubiquity and persistence of business groups requires explanation.

What follows is a brief overview of why pyramidal business groups seemingly ought to magnify agency problems. This done, we turn to explanations of their popularity and persistence.

Agency problems (Jensen and Meckling 1976) arise from an internal contradiction in microeconomics: individuals are presumed to maximize their utility, firms are presumed to maximize their profits, but CEOs are individuals who run firms and might well run them to maximize their own utility. Where agency problems are worse, public investors pay less for firms' shares in initial public offerings (IPOs) by an amount called an *agency cost*. A pervasive misapprehension in much recent work is that agency costs reflect insiders expropriating public shareholders' wealth. In an efficient stock market, agency problems reduce the value of a firm's shares to account for the expected behavior of its insiders when the shares are first issued). Public shareholders buy in at low prices, and get (on average) exactly the returns they expected. The social cost of agency problems is not the expropriation of shareholders' wealth, but the depressed return to entrepreneurs for founding new firms and selling out in IPOs – the venture capital cycle Gompers and Lerner (2006) find central to the financing of continual innovation. Higher agency costs mean entrepreneurs glean lower returns, all else equal, from founding and listing new firms.

A huge literature on corporate governance (Shleifer and Vishny 1997) examines how laws, regulations, corporate charters, etc. affect agency problems. This corporation-level focus is reasonable in the United Kingdom and United States, where business decisions are indeed made by firms' CEOs and boards of directors; but loses traction elsewhere, where important decisions are often made at the level of the business group. Business group governance, though obviously related to corporate governance, raises new and different issues (Morck 2011).¹³

First, pyramidal business groups hugely magnify the separation of ownership rights from control rights that underlies agency problems. The family controls the firm at the apex of its pyramid, and usually owns much of it too. Any misallocation of the family firm's resources directly diminishes the family's wealth, and is thus likely to be avoided. But the fortunes of individual firms in lower tiers can

¹² Higher agency costs leave a firm's shares trading at lower prices. Corporate raiders are posited to buy the shares of such firms, delist them, restructure them to reduce agency problems with credible new constraints of managerial utility maximization at the expense of profits, and refloat the firms' shares in the stock market at a higher price than that paid in the takeover. Economies in which takeovers are commonplace, such as those of the United States and United Kingdom, thus exert a constant pressure on firms towards minimized agency costs (Shleifer and Vishny 1997), Franks et al. (2005) argue that raiders finance their takeover activity with continual issues of new shares, diluting their stakes in their own firms, and posit that more extensive takeover activity is responsible, partly at least, for the greater importance of widely held firms in those countries.

¹³ What follows pertains to pyramidal business groups because these are by far the predominant structure of large business groups, both across countries and historically. The issues raised also pertain to 19th century American business groups organized as voting trusts, with minor variations. State controlled business groups, such as attained importance in Fascist Italy (Aganin and Volpin 2005) and comprise most of the private sector in modern China (Fan et al. 2012) potentially bestir radically different agency problems associated with political agendas compromising economic efficiency.

have scant effect on the controlling family's wealth. Consider Imperial Windsor, a member firm in a 1990s Canadian business group described in Morck, Stangeland and Yeung (2000). The Bronfman family's Broncorp Inc. controlled HIL Corporation with a 19.6 percent equity block. HIL controlled 97 percent of Edper Resources, which controlled 60 percent of Brascan Holdings, which controlled 5.1 percent of Brascan, which controlled 49.9 percent of Braspower Holdings, which controlled 49.3 percent of Great Lakes Power Inc, which controlled 100 percent of First Toronto Investments, which controlled 25 percent of Trilon Holdings, which controlled 64.5 percent of Trilon Financial, which controlled 41.4 percent of Gentra, which controlled 31.9 percent of Imperial Windsor Group. Multiplying the chain of ownership stakes reveals that a one million dollar drop in the value of Imperial Windsor would cost its controlling family about \$300. Assuming public shareholders owned all other shares in each firm along the control chain, Imperial Windsor is 99.97% financed with public shareholders' money and only 0.03% financed with wealth provided by the family. Consequently, the separation of ownership from control is precisely equivalent to that in a widely held company whose top managers owned a 0.03% stake.

If the controlling family, or managers, spent a million additional dollars of their firm's money on unnecessary executive jet flights they valued at over \$300, the insiders' utility would rise as the firm's value fell. If the managers of the widely held firm went too far down this path, their firm's depressed share price might attract a hostile takeover by a raider intent on replacing them with less epicurean top managers. The business group member firm is, however, not at similar risk. The business family controlling the group's apex firm controls every firm in the pyramid utterly, by dint of controlling its parent company, its parent's parent, and so on. As long as managers and directors throughout the structure please its controlling family, their positions are secure: they and the controlling family are entrenched. Should the family patriarch be senile or venal, neither he nor the cronies he places in charge of his group firms, can be ousted by a raider, a shareholder rebellion, or an institutional investor. Indeed, the institutional investors in many countries are themselves pyramidal group member firms.

In America or Britain, both currently economies of freestanding firms, bereft of business groups, widely held firms endure agency problems associated with insiders spending public shareholders money and narrowly held firms bear agency problems associated with entrenched insiders (Morck, Shleifer and Vishny 1988; Stulz 1988). Pyramidal groups neatly allow both problems in the same firms.¹⁴

Moreover, pyramiding allows a third agency problem, dubbed tunnelling (Johnson et al. 2000), in which net worth is transferred from low to high tier pyramid group firms, to augment the controlling family's private wealth. This is typically accomplished with transfer pricing, intragroup intercorporate transactions at non-market prices of the same sort that multinationals use to move taxable income from country to country.¹⁵ Understandably, the public shareholders of wealth-contributing firms view tunnelling as a corporate governance problem; and laws and regulations against tunnelling are found to matter most empirically in explaining variation in financial development across countries.

¹⁴ Negative effects of concentrated voting control on firm-level performance correlate with the extent to which the controlling shareholders' voting power exceed their cash-flow rights – that is, their actual ownership of the firm's shares (Faccio et al. 2001; Claessens et al. 2002; Edwards and Weichenrieder 2004). Attig et al. (2004) also show this gap to correlate with lower liquidity for the firm's public float – that is, the shares not part of the pyramidal control structure and owned by public investors.

¹⁵ Bonbright and Means (1932) posit that overpriced or underpriced intragroup services fees, harder to detect than mispriced goods, are a preferred method of tunneling. For example, an engineering services or financial firm might sell overpriced services to another group firm as a way of tunneling funds out of that firm, and might provide services at cut rates as a way of tunneling funds into another group firm in need of subsidies.

4.2 Oligarchs and Peons

Cross-country studies correlate a pre-eminence of large family-controlled business groups with all manner of institutional deficiencies. Inefficient capital, labour and product markets; poor transportation, communication, power, and water infrastructure; deficient public education; interventionist government, high inequality and low incomes all correlate with larger or more dominant family business groups (Fogel 2007).

This does not appear to be a cross-sectional photograph of early-stage Big Push development featuring large business groups and mature industrialization featuring more atomistic business sectors. Overall, a predominance of large old-moneyed family-controlled business groups correlates with slower, not faster growth (Morck and Yeung 2004; Fogel 2007).¹⁶ On the surface, this seems paradoxical: the firms in family business groups are the best performing firms in developing economies (Khanna and Yafeh 2007), so one might think more of them would be better for the economy. This might indeed be so, but what is good for Tata Motors need not be good for India. To understand why, we must look at some examples.

Country studies of seemingly interminably developing economies reveal remarkably old and stable family business groups dominating their economies (Colpan et al. 2010). While smaller new business groups wax and wane through India's economic history, those of the Birla and Tata families remained overwhelmingly dominant from the Raj, through most of India's history as an independent nation (Khanna and Palepu 2005). Only in the past few years has a third group challenged their diarchy. Roughly one third of Argentina's large business groups are controlled by their founders' sons, another third are controlled by their founders' grandsons, and the remaining third are controlled by their founders' great-grandsons (Fracchia et al. 2010). Further cross country evidence reveals rapid growth in economies dominated by self-made tycoons' business groups, but very slow growth in economies dominated by old-moneyed families' business groups – or business groups controlled by political leaders (Morck, Stangeland and Yeung 2000). Of course, the very poorest countries lack stock markets, and hence business groups.

These findings suggest that countries might become trapped in a “middle income trap”, a stable and prolonged situation in which a few large business groups dominate an institutionally deficient economy, and protect their dominance by preventing further institutional development. The last can be accomplished by capturing regulators or even whole governments, or by controlling a country's banks and thus potential entrants' access to capital (Rajan and Zingales 2003, 2004). If business group firms achieve their profits primarily from political rent-seeking, findings that business group firms' profits surpass those of independent firms in low income countries (Khanna and Yafeh 2007) need not imply that the group firms are better managed; rather, group firms' profits may have major negative externalities for their economies (Morck, Wolfenzon and Yeung 2005).¹⁷ Thus, that firms controlled by

¹⁶The direction of causality cannot be directly inferred from correlations. A predominance of large family-controlled business groups might keep an economy from developing, or countries in the early stages of development might be preferential environments for large family controlled business groups, or both. The preponderance of empirical evidence, much of it admittedly circumstantial, suggests “both”. Thus, bidirectional causality is central to the arguments below.

¹⁷*Political rent-seeking* (Kruger 1976) occurs when firms invest in political connections, as opposed to productive assets. Baumol (1990) argues that large, invasive, and corrupt governments can make political rent-seeking the highest return investment available to most firms, and that this can stall economic development. This can be a stable situation in which the rent-seeking firms do well – their investments in government connections yield high returns in subsidies, trade protection, tax breaks, and protective barriers to entry; as do the politicians who favor them; but the economy suffers from a lack of genuine investment in productivity-improving assets and thus stagnates (Morck, Wolfenzon and Yeung 2005). We refer to this as a “middle income trap”.

Russian oligarchs are the country's best performers (Guriev and Rachinsky 2005) need not imply that oligarchs ought to control more firms.

Robber barons, oligarchs, and the like are roundly blamed for many countries' economic injustices. While the corporate governance literature stresses agency problems associated with pyramids, country histories tend to stress broader problems. The predominance of a few very large pyramidal groups evokes broader political economy concerns. Where a handful of very large business groups comprise much of an economy's big business sector, capital allocation can depend more on the controlling shareholder's preferences than on market forces. This could enhance efficiency if the controlling shareholder has superior information, judgment, and appropriately aligned incentives; but might also misallocate resources severely.

Long-run sustainable economic growth is thought to require creative destruction, wherein innovative high productivity upstart firms continually arise and displace established lower-productivity firms. King and Levine (1993) show that creative destruction requires financial development because the creative entrepreneurs with potentially disruptive new ideas are unlikely to get financing from the large existing firms or business groups that stand to be destroyed. Those who are already rich and powerful tend to prefer the status quo. Indeed, they might divert capital to lower return projects within their established firms rather than to far more profitable ventures that would be controlled by outsiders (Almeida and Wolfenzon 2006). Similar considerations work against groups financing competitors to their established firms, allowing concealed cartelization despite an appearance of numerous competing corporations (Morck, Wolfenzon, and Yeung 2005). Economies dominated by large business groups might thus depend critically on established firms' cautious application of foreign innovation for productivity growth, and on trade openness for competitive pricing. The same reputation, information, and coordination advantages that let group firms do business with lower transactions costs in institutionally weak economies also render groups' controlling shareholders better able to influence government officials, evoking the possibility that group firms' superior economic performance might arise, in part at least, from advantages in political rent-seeking, rather than resource allocation (Morck and Yeung 2004). More fundamentally, where too few controlling too much, a family patriarch's error in judgment can become a macroeconomic crisis.

4.3 Commissars and Cadres

Central planning is usually thought of as a government function. Paul Rosenstein-Rodan (1943), one of the 20th century's most influential economists, argued that "the problem of economic underdevelopment" is one of financing and coordination. Each firm in a modern market economy depends critically on the simple existence of sufficient populations of firms to sustain competitive prices throughout its vertical supply chains and those of makers of relevant complementary goods, as well as the existence of infrastructure public goods. In rapid development starting from a low level, many nodes in this network are missing. Filling in these missing pieces has huge benefits for the rest of the economy, but the first firms to do so cannot readily capture these returns. Indeed, hold-up problems (Williamson 1975) can deter first movers and development stalls. To overcome these problems, he called for a Big Push: a foreign aid-financed government-coordinated industrial policy in which large state-owned enterprises would coordinate the development of all sectors of the economy. Only a state-led Big Push, he argued, could overcome the multitudes of hold-up problems, externalities, and incomplete network problems that stymie investment by private enterprise and lock poor countries into low-level equilibriums.

Rosenstein-Rodan's characterization of the problem stands unrefuted, and remains a central theme of development economics (Murphy, Shleifer and Vishny 1989). His solution, however, aged poorly. Like its better-known cousin, the natural resources trap (Sachs and Warner 2001), a foreign aid

trap can undermine the quality of recipient countries' governments (Easterly 2006; Djankov et al. 2008). Just as plentiful natural resources royalties plump politicians' budgets without any real attention to genuine development, huge aid inflows fixate politicians' attention on pleasing donors. In both, genuine development is at best unnecessary to the political elite, and may even seem undesirable for empowering troublesome upstarts. Massive state-led industrial policies are even more thoroughly discredited (Ades and di Tella 1997). Political rent-seeking (Krueger 1974), regulatory capture (Stigler 1971), and corruption (Shleifer and Vishny 1993) are now widely accepted as first order problems throughout economics, and few policy options provide them a broader invitation than does Rosenstein-Rodan's state-led Big Push.

Through the 1950s and 1960s, Rosenstein-Rodan and his London School of Economics students organized state-led Big Push industrializations in scores of newly independent African, Arab, and Asian, countries; and even found followers in the long independent, but economically stagnating economies of Latin America. Half a century later, most economies in Africa, the Arab world, and Asia remain mired in poverty, bound by seemingly intractable corruption, rent-seeking, and elite capture. The handful of Asian economies that successfully developed into high-income economies in the latter 20th century – Hong Kong, Malaysia, Taiwan, and South Korea – entrusted their economies to powerful tycoons and business families, whose fortunes rose with development, not Rosenstein-Rodan's SOEs and central planners. Rosenstein-Rodan erred in not anticipating the rent-seeking, capture, and other government failure problems that ensued, but so did the mainstream economics of his era.

Rosenstein-Rodan (1943) felt state-control was essential because finance concerned individual corporations: "Financial markets and institutions are inappropriate to the task of industrialization of a whole country. They deal with too small units, and do not account for externalities. Capital goes to individual firms ... There has never been a scheme of planned industrialisation comprising a simultaneous planning of several complementary industries."

Rosenstein-Rodan was right (more or less) about the problem, but wrong about the solution. Large pyramidal business groups are fully capable of the "simultaneous planning of several complementary industries". Indeed, their primary function may well be internalizing network externalities, circumventing hold-up problems, and privately providing public goods: precisely the tasks Rosenstein-Rodan's Big Push assigns to governments. Japan's development is widely cited as a successful state-run Big Push (e.g. Ohkawa and Rosovsky 1973), but its economy staggered until its zaibatsu took charge (Morck and Nakamura 2007). South Korea's government largely abandoned direct intervention, except in sectors related to military supply lines, in the 1970s; and by the 1980s had overtly neoliberal government policies (Lim and Morck 2012). The economy rose from third to first world levels from the late 1970s through the 1990s. Even during the 1960s, arguably the period of heaviest government intervention, subsidies were dependent on exporting success (see the chapter by Bruland and Mowery in this volume). It seems likely that business groups served as private-sector central planners in both the distant economic histories of developed economies and present day rapidly developing economies.

China may or may not fit this pattern. Virtually all large firms classified by the government as privately owned are, in fact, member firms in pyramidal groups with state-owned enterprises, rather than business families, at their apexes (Fan, Wong, and Zhang 2012). Such structures were prominent in Fascist Italy (Aganin and Volpin 2005). However, state control may veil de facto control by powerful families of "princelings" – the direct descendants of the communist revolutionaries who founded the People's Republic. After documenting the top state-owned enterprise positions of 103 descendants of

the “eight immortals” – all now dead and revered in communist lore as transcendent revolutionary figures – a Bloomberg analysis concludes:¹⁸

“Twenty-six of the heirs ran or held top positions in state-owned companies that dominate the economy ... Three children alone -- General Wang’s son, Wang Jun; Deng’s son-in-law, He Ping; and Chen Yuan, the son of Mao’s economic tsar -- headed or still run state-owned companies with combined assets of about \$1.6 trillion in 2011. That is equivalent to more than a fifth of China’s annual economic output.”

Free-market analogs of Soviet central planners, the controlling shareholders of such business groups – by coordinating investment in numerous diverse sectors, by controlling the major decisions of all the firms in their groups, and by tunneling funds from one member firm to another – can internalize externalities, prevent hold-up problems, and even organize the private provision of public goods – at least in theory (Morck 2009). But unlike Soviet central planners, the tycoons who orchestrated the successful development of Canada, Japan, South Korea and Sweden used markets and public capital, and built personal fortunes that grew with development. Incentives were aligned.

Morck and Nakamura (2007) document evidence of Japan’s zaibatsu families behaving in this way in that country’s high growth era – the late 19th and early 20th centuries. Turkey’s major business groups each operate a private university – investments perhaps made profitable by the very high likelihood that graduates will ultimately end up working for a group company, there being few other choices.

In an admirably complete explanation of how a business group can naturally find itself organizing a Big Push across multiple sectors, Koo Cha-Kyung, Chairman of Korea’s LG pyramidal business group, explains how business groups overcome Rosenstein-Rodan’s litany of coordination problems thus (Kim 2010):

“My father and I started a cosmetic cream factory in the late 1940s. At the time, no company could supply us with plastic caps of adequate quality for cream jars, so we had to start a plastics business. Plastic caps alone were not sufficient to run the plastic molding plant, so we added combs, toothbrushes, and soap boxes. This plastic business also led us to manufacture electric fan blades and telephone cases, which in turn led us to manufacture electrical and electronic products and telecommunications equipment. The plastics business also took us into oil refining, which needed a tanker shipping company. The oil refining company alone was paying an insurance premium amounting to more than half the total revenue of the largest insurance company in Korea. Thus, an insurance company was started. This natural step-by-step evolution through related businesses resulted in the Lucky-Goldstar (LG) group as we see it today.”

5. Graduation Exercises

Once the Big Push phase of industrialization is complete, and the institutions allowing low-cost arm’s-length transactions fall into place, the business groups’ raison d’être fades and their litany of agency problems and political economy concerns loom large. Like institutions favoring any powerful vested

¹⁸Oster et al. (2012). The eight immortals – Deng Xiaoping, Wang Zhen, Chen Yun, Li Xiannian, Peng Zhen, Song Renqiong, Yang Shangkun and Bo Yibo – play a near mythical role in official Chinese history akin to that of Washington, Jefferson, Hamilton, or Lincoln in the United States.

interest, family-controlled pyramidal business groups tend to persist until a major crisis disturbs the status quo, erodes the wealth of entrenched elites, undermines the faith of the general populace in existing institutions, and creates what Olsen (1984) calls a “clean institutional slate”. The 20th century’s greatest economic shocks – the European hyperinflations of the 1920s, the Great Depression of the 1930s, World War II, and ideologically polarized Cold War economic policy flips – affected different countries’ great pyramidal business groups in very different ways.

5.1 Business Groups at the End of History?

Large pyramidal business groups persist in some highly developed economies. But they are housebroken. Their controlling families strive to be seen as good citizens, and are often keen to cooperate with popular governments.

Sweden serves as a prime example of this path (Hogfeldt 2005). Two large pyramidal business groups control firms amounting to roughly half of the stock market capitalization of all listed Swedish businesses. How Sweden’s business groups reacted to the Great Depression and how they adopted to an ideologically-driven social democratic economic experiment thereafter cast much light on political economy issues concerning such groups. Sweden’s late 19th and early 20th century “catch-up” industrialization featured business groups similar to Japan’s *zaibatsu*. In discussing the latter decades of this era, Dahmen (1950) highlights *development blocks* –interdependent sectors developed in concert.

A wave of bankruptcies left Sweden’s largest banks holding huge inventories of industrial firms’ nonperforming loans. The two largest creditors, the Wallenberg family’s group of financial institutions and Svenska Handelsbanken, accepted equity in lieu of debt repayment and assembled these into pyramids of control blocks. Swedes reacted to the Great Depression by voting in an almost back-to-back succession of Social Democratic governments over the next several decades. Social Democratic prime ministers and business family patriarchs initially got on poorly. But over time, the Social Democrats came to appreciate the convenience of “doing deals” with big business with a few phone calls, and the patriarchs came to appreciate the barriers to entry inherent in high taxes, dense regulations, and industrial policy subsidies. Strong labour laws and penetrating disclosure requirements arose to preclude tunnelling. A symbiosis developed that many Swedes, including ardent Social Democrats, view as highly practical and beneficial.¹⁹

Italy’s economy featured several very large pyramidal business groups in the early 20th century (Aganin and Volpin 2005). Amid a 1920s bank crisis, Benito Mussolini seized power and nationalized the problem banks. The SOE banks then accepted equity blocks in industrial firms in lieu of debt repayment, and assembled large pyramidal groups with state-owned enterprises, rather than family firms, at the apexes. These structures helped promulgate Fascist Party control across a still nominally private sector economy or listed firms with distinct CEOs and boards of directors. But the pyramidal control blocks ensured that each member firm’s board had a solid Party majority. These structures appeared useful to

¹⁹One commonly perceived benefit of pyramidal business groups in Sweden is the insulation of group member firms from the short-term performance pressures exerted by public shareholders, allowing business-government cooperation in the development of new technologies. For example, the Wallenberg pyramidal group firm L. M. Ericsson developed a state-financed digital technology to achieve prominence in telecoms. However, evidence that public shareholders exert short term pressures on managers is largely anecdotal, and empirical studies point to the opposite: firms’ share prices rise abruptly on news that they are increasing R&D spending in the U.S. (Jaffe 1986; Chan et al. 1990; Doukas and Switzer 1992; Chan et al. 2001), Canada (Johnson and Pazderka 1993), and Europe (Hall and Oriani 2004). While, a role for the state in financing basic research persists in successful developed economies throughout the world, state-financed commercialization tends to increase returns to political rent-seeking (Gompers and Lerner 2004, c. 13).

postwar governments, and persisted until a 1980s mass privatization program; whereafter family controlled business groups staged a comeback. The country's largest business group today, that of the Agnelli family, was also its largest before Fascism.²⁰

Canada perhaps provides the best examples of pyramids dying of natural causes (Morck, Percy, Tian and Yeung 2005). No radical political transformation upset that country's old-line parties in the Great Depression, and its postwar politics remained largely centrist. Its early 20th century business groups simply persisted. Some groups dissolved amid 1930s bankruptcies; others grew by buying up bankrupt families' dismembered subsidiaries. A steep inheritance tax, in effect until the 1970s, forced heirs to sell companies and pared down older groups even as new ones formed.²¹ Business groups resurged dramatically in the 1970s as the country adopted a Social Democratic model, and then fell away again amid post-1980s liberalizations. It seems plausible that competition from more efficient firms in the United States and elsewhere may have had a role in this.

Nonetheless, Canada has never sought to banish pyramidal business groups. Rather, the country seeks to domesticate them. A central pillar of Canada's business law is its Oppression Remedy. This lets shareholders, and other designated stakeholders, reach up through successive tiers of control blocks to sue personally a firm's ultimate controlling shareholder for acts deemed oppressive. Though seldom used, this shareholder right is thought far more important than shareholder rights deemed important in the United States. Djankov et al. (2008), in a cross country study, show laws of the Canadian ilk to be the most important constraints on agency problems in most countries. As explained below, the United States forged a unique path away from a business group dominated economy, and consequently has unique institutions.

How business groups should be governed remains an open question. Other countries have developed very different bodies of fully articulated business group law. For example, Belgian law requires officers and directors of group member firms to act in the best interests of the business group, not their specific firm (Johnson et al. 2000). Economists, focused on the governance of singleton corporations, have barely scratched the surface (Morck 2011).

5.2 The End of History for Business Groups?

A high income economy's Big Push commencement exercise can be traumatic for the graduating class of business group controlling shareholders. Successful development brings efficient markets and high quality public goods, such as education and public health, all of which highlight the problems of inherited corporate governance: a regression to the mean in talent, blunted incentives for non-kin and excessive job security for kin in family firms, and disruptive feuds between quarrelsome princes and princesses. Chandler (1977, 1990) associates economic development with a waning of family controlled

²⁰ Aganin and Volpin (2005) document family controlled pyramidal business groups being somewhat overshadowed by state-controlled pyramidal groups from the 1920s until a privatization drive in the 1990s; after which family controlled business groups regained their early 20th century dominance.

²¹ Political economy aspects of these reforms are complicated, but almost certainly very important. Pierre Trudeau, whose father Charles Trudeau controlled a small business group, abolished the estate tax in 1972. The replacement, capital gains realization on death, was amended in 1974 to allow family trusts to postpone this for a generation or more. Political pressure from wealthy business families nonetheless persisted. In 1986 and 1991, a branch of the Bronfman family allegedly sought permission to move \$2.2 billion, in such a trust, out of the country without triggering a realization, effectively avoiding all taxes on the estate. Allegedly, Revenue Canada denied permission, but was overruled by the Finance Ministry and the funds were transferred. See Peter C. Newman "The soft touch of an ace tax collector", *Maclean's* June 10, 1996; Diane Francis (2000) "The crusade to know what went on at Revenue Canada" *National Post*, August 26, 2000.

business and a waxing of professionally managed firms. As evidence, he documents such transformations in four major economies: America, Britain, Japan, and Germany. While family firms persist in all four, and comprise much of Germany's vaunted *Mittelstand* of small and medium-sized enterprises, Chandler's observation is essentially valid. In each case, major economic shocks wrought this transformation.

In the United States, the shock was the Great Depression (Morck 2005). In the late 1920s, pyramidal business groups attracted increasing criticism for avoiding taxes through opportunistic tunnelling, concealing cartels, destabilizing the economy, and entrusting too much economic power to too few people. President Roosevelt's New Deal, launched in the mid-1930s, took direct aim at business groups, applying double taxation to intercorporate dividends, banning large pyramids from public utilities sectors, and dangling tax incentives to families that broke-up their pyramids. By the late 1930s, the pyramidal groups previously evident across most sectors of the US economy had all but vanished.²² Most large US firms are now widely held, lacking any single dominant shareholder; and virtually all are freestanding. Listed US firms do not hold control blocks in other listed US firms, except when a takeover or divestiture is in progress.

In Germany, a hyperinflation and the Great Depression brought Adolf Hitler's National Socialist Party to power (Weitz 1997; Fohlin 2005, 2007). The families that controlled Germany's great pyramidal business groups often used control chains containing dominant, but not majority equity blocks. To extend Party control over the country's private sector businesses, the Nazis altered shareholder voting rules, vesting public investors' votes with the banks that served as custodians for their shares. Aryanising the country's largest few banks then left Party loyalists with majority voting control sufficient to control the boards of most large German firms. Directors' duty to shareholders was replaced by a duty to all stakeholders: shareholders, creditors, workers, the community, and most importantly, the Reich and its Führer.

With minor modifications, this system remains in place today. Most large German firms have professional managers primarily loyal to the country's most powerful bankers, whose voting power determines their careers. Since the large banks are widely held, the bankers jointly control elections to their own boards.

Japan endured a series of devastating crises in the 20th century (Morck and Nakamura 2005). A 1923 earthquake destroyed much of its industrial base, and the Great Depression's trade barriers idled more. With popular support for liberal democracy waning, the military slowly assumed power with a policy of selective assassination. A series of reforms inserted military personnel into companies and onto boards, and military planners soon dictated investment, payout, and production decisions.

Japan's surrender and postwar occupation was, if anything, an even bigger crisis. The economy the American military took charge of in 1945 was so tightly controlled by the military that it resembled a centrally planned Soviet economy. Roosevelt New Dealers, charged with rebuilding Japan, saw no

²² Mahoney (2012) notes that many U.S. pyramidal groups contained public utility firms, with regulated cost-plus pricing, making them not only cash cows (sources of subsidies for other group firms), but mechanisms for turning high costs into high profits (cost-plus pricing sets rates so that profits are always a given figure times costs). Concerns that other firms in groups with public utility operations were unfairly advantaged at the expense of public utility rate payers led to the 1935 Public Utilities Holding Companies Act, which limited public utility pyramiding to two tiers. This act was almost certainly paramount in forcing the dismantling of pyramids whose main edge was the regulated profits of their utilities affiliates. Although many U.S. pyramids were indeed involved largely in public utilities (Bank and Cheffins 2010), many others contained railroad, financial and industrial firms (Morck 2009). The importance of regulated utilities with cost-plus pricing as pyramidal group cash cows in other countries is incompletely investigated.

reason to return firms to the families whose pyramidal groups dominated the prewar economy. Instead, family and intercorporate control blocks were seized and either sold or allocated to workers. When the Americans departed in 1952, Japan's corporate sector looked much like America's now: Most large firms were freestanding and widely held.

Two waves of hostile takeovers ensued, with raiders buying control blocks in underperforming firms and threatening their managers with dismissal. This ended with Mitsui Bank's invention of a new antitakeover defence: the keiretsu business group. The tactic assembled a dozen or two firms, each of which created new shares numbering more than their public shares outstanding. These shares were then traded among the participating companies so each ended up holding one or two percent of the stock in every other member firm in the group. The resulting configuration left each firm without any single controlling shareholder, yet insulated its managers from the threat of a hostile takeover because all managers pledged never to sell their stakes, which when summed constituted a majority of every group firm's stock (Lazonick 2004).

Keiretsu business groups, though never substantially more than antitakeover devices, attracted the favourable attention of outside experts amid Japan's 1980s boom. Keiretsu member firms' longstanding financial underperformance now attracts criticism from investor groups, and many large keiretsu appear to be dissolving. Former keiretsu firms are now enthusiastically adopting poison pills.

The United Kingdom, devastated by Depression and war, elected a series of radical Labour governments in the postwar era (Franks et al. 2005; Cheffins 2009). These organized trade-based pension funds, which soon became major shareholders in large British firms. Unhappy with the laggard performance of the public floats of pyramid group member firms' shares, the pension funds successfully lobbied the London Stock Exchange for a change in its takeover rules. The new 1968 Takeover Rule requires any shareholder who acquires a 30% stake in a listed firm to buy 100%. Hurried along by raiders and pension fund activism, pyramidal groups largely disappeared.

Elsewhere, Chandler's prediction that economic development heralds professional management remains unfulfilled (La Porta et al. 1999). But it may be slow in coming rather than wrong. Tested techniques for dissolving pyramidal business groups are attracting public policy interest in many countries whose self-made tycoon-run business groups are about to pass to heirs or less certain talent. South Korea's chaebol are taking increasingly heavy fire (Kim 2006; Albrecht et al. 2010); and Israelis are reflecting on the power of their pyramids (Kosenko 2007). Conflicts between princelings over inheritances and succession may be weakening the power of business groups in these countries and elsewhere (e.g. Bertrand et al. 2008).

5.3 Is there a future in resisting history?

If large pyramidal business groups are valuable because they can coordinate Big Push development, but become net drags on economic growth once an economy attains First World status, their unwanted persistence becomes a public policy problem. Large business groups, by facilitating successful Big Push development, undermine their *raison d'être*. The powerful families, whose economic and social status depends on the continued importance of their business groups, might thus come to see developmental success as a problem, rather than an objective.

Rajan and Zingales (2003, 2004) show that many countries experienced a spurt of financial liberalization, but then reversed this once an initial set of entrepreneurs obtained capital to build business groups. They suggest that this first generation of successful business families pressed for financial atavism to lock in a favorable (to them) status quo. By slowing the pace of development, or even bringing it to a halt, they retain their economic and social prominence. But their countries remain stuck part-way through the process of economic development.

A growing literature documents how many countries become stuck in a “middle income trap” (Eichengreen et al. 2011). Once they have taken control of the commanding heights of an economy, as they must to coordinate Big Push development, large business groups may be very hard to dislodge. They can divert free cash flows from their resources firms, regulated utilities with guaranteed rates or return, government guaranteed financial institutions, and so on to sustain their other firms, and even engage in bouts of predatory pricing to deter competition. As long as their controlling shareholders value the social and economic benefits of staying in control more than the wealth they might obtain from continued development, the situation persists.

Stalled development is more than a local problem. First World economies have come to rely on rising demand from emerging economies, most notably China and India. Economic distortions emanating from these globally significant economies could easily have global costs. More generally, stalled development in the Developing World means sagging demand for developed economies’ exports. And perhaps most importantly, stalled development squanders the potential talents of millions of people and slows the overall progress of the species. We have too many problems in urgent need of solutions to waste minds and talent.

6. Conclusions

Business groups can play an important role in early-stage development of a capitalist economy. Every firm in a developed capitalist economy depends implicitly on a huge network of institutions and other firms that set input, output, and complementary good prices efficiently. Without these, a host of network externalities, hold-up problems, and other market failures can retard industrialization. Arguably, early industrializers took centuries to develop; in part at least because these problems were overcome slowly by trial and error. Suspending market forces and entrusting government central planners to allocate resources works poorly because another host of even more development-retarding government failure problems arise. Business groups can be private-sector mechanisms for internalizing network externalities, preventing hold-up problems, and overcoming other institutional deficiencies – and for promoting rapid development envisioned by advocates of Big Push industrialization. Large business groups thus feature prominently in the histories successful late industrializers and in today’s rapidly industrializing economies. Pyramiding was perhaps invented too late to coordinate rapid industrialization in pioneer economies, such as Britain.

After a successful Big Push, business groups’ inherent potential for governance problems and ability to transcend market forces can become a net liability (Morck, Wolfenzon and Yeung 2005). Of course, they need not do so: many developed economies retain large business groups, subject to potent transparency, anti-self-dealing, and other legal and regulatory constraints. Others, most notably the United States and United Kingdom, adopted tax and regulatory policies explicitly designed to dissolve business groups into independent corporations. Especially tumultuous economic and political histories left still others, notably Japan and Germany, with uniquely structured business groups and more limited rosters of traditional family-controlled pyramids. As Olson (1984) shows, major institutional changes tend to follow major crises that dislodge vested interests. Consistent with this logic, the different ways different countries reorganized corporate control in reaction to major crises played major parts in the development of different “flavors” of capitalism (Morck and Yeung 2009).²³ Similar choices now confront today’s newly developed economies, or soon will. Economic history weighs against the continued unfettered dominance of a few large business groups, but provides several seemingly viable alternative policy options.

²³ Although sociologists have developed a rich literature on “varieties of capitalism” (Hall and Soskice 2001), many finance and economics issues remain open. Further research into these issues is clearly warranted.

Economies that are always developing, but never developed, may be caught in a “middle income trap” because of a time inconsistency problem: large family controlled business groups may ex ante favor rapid development, but stymie development ex post.²⁴ Large family controlled business groups can lead a developing economy into the First World: they have done so in Japan, South Korea, and elsewhere. But by doing this successfully, they render themselves economically unnecessary. Where this prospect threatens a status quo favorable to their controlling shareholders, we suggest that a developing economy’s business elites might react by slowing, or even stopping the pace of development.

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²⁴ Time inconsistency problems (Kydland, and Prescott 1977) occur throughout economics – wherever a naively optimal strategy, if successful, changes conditions to render itself suboptimal.

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