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Corporate Governance versus Business Group Governance (Part 2: The Middle-income Trap)

Luis Alfonso Dau,[a] Randall Morck,[b] & Bernard Yeung [c]

Abstract

Business group governance supersedes corporate governance in catch-up development, but can hamper ongoing growth through creative destruction. Business groups balance an innovative firm's gains against disruptions to a legacy firm, slowing growth by innovation. After catch-up growth runs its course, corporate governance eclipses business group governance as growth by innovation lifts economies to high-income status. Catch-up economies that fail to make this change can linger in a middle-income trap. Many mid-20th century development policies impede this changeover.

Keywords: Middle-income trap, creative destruction, business group governance, corporate governance, political rent-seeking.

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a. Northeastern University, L.Dau@northeastern.edu
b. University of Alberta Business School, rmorck@ualberta.ca
c. National University of Singapore Business School, byeung@nus.edu.sg.

Introduction

The previous chapter explains how corporate governance creates network externality problems that lock in a low-income trap and how business group governance provides an escape route to rapid catch-up development. This chapter argues that switching from catch-up growth to high-income growth requires abandoning business group governance and prioritizing corporate governance. High-income growth is a process of creative destruction – creative innovative firms destroy, or at least disrupt, legacy technology firms.

Creative destruction works best if every firm is out for itself. Business group governance is apt to balance the benefits to an innovative group firm against the costs to a disrupted legacy group firm, but ignores the social benefits of better technology becoming generally available. Under every-firm-for-itself corporate governance, the innovator may care about neither legacy firms nor overall economic growth, but is nonetheless apt to innovate more and thus contribute to faster sustained high-income economy growth.

Avoiding Corporate Governance for First Stage Growth

In a market economy, every firm relies on an external network. Each firm needs suppliers and customers, suppliers' suppliers and customers' customers, and so on throughout densely interconnected product chains. Every firm also relies on all those firms' competitors keeping prices in line, on consumer spending by all of their employees, and on taxes on all of this economic activity funding courts, police, and other public goods. We say the network's externality value to each firm is the firm's value within the network minus its hypothetical value standing alone in a subsistence economy.

Without the network, firms do not form; without firms forming, there is no network. This is a network externality problem the previous chapter dubbed the low-income trap.

That chapter shows how business group governance let an economy escape this trap by letting a common controlling shareholder coordinate the rollout and expansion of multiple interdependent firms in diverse industries to make each serve the needs of the others. A network of interdependent firms thus arises within each business group. The value of each firm in the group rises as the group's network forms, expands, and reaches completion. The economic engine powering rapid catch-up growth is the conversion of network externalities from a problem to a wealth generator.

This explains why business groups arise during rapid catch-up development in most high-income economies.[1] However, past glories becomes today's relics. Once each major business group has expanded to capture all potential positive network externalities, catch-up development has run its course. Continued ascent to high-income status requires a second stage engine of growth.

High-income economies grow by creative destruction. Creative firms develop new technologies

[1] Britain, a notable exception, industrialized slowly over some two centuries, new technologies, legal reforms, and market development occurring intermittently. Many firms seemed chronically starved of capital (Williamson, 1984). Rapid catch-up growth seeks to avoid this.

that destroy or disrupt legacy firms but elevate economy-wide productivity. Innovators' patents are licenses for legal hold ups, but expire when a rival innovator disrupts them in turn. Legacy firms are reluctant to destroy their existing assets, so creative innovators tend to found new firms.[2] Business groups, in particular, are likely to be replete with legacy firms because rapid catch-up industrialization can utilize off-the-shelf technologies. Innovation is a distraction when achieving positive network externalities is the most powerful wealth creator around.

Consequently, innovation-driven growth requires that creative entrepreneurs be able to form new firms. However, any new firm also needs suppliers, customers, and the whole network that is a developed free market economy. At the end of rapid catch-up growth, several groups may each have a member corporation in each industry. The network might be well populated with corporations, but if all lie within some business group, and business groups dislike innovation, network externalities can withheld from disruptive upstarts.

Corporate governance displacing business group governance frees every firm throughout the network to compete with its industry peers without regard for other group firms. Each well-governed corporation maximizes profits by doing business with an upstart innovator offing better terms. Innovators innovate without regard for the destruction of legacy firms, other firms benefit from continual innovation, and the economy ascends to high-income status.

The Middle-income Trap

Economic development appears to be a two-stage rocket. The first-stage engine runs on business groups capturing positive network externalities. The second stage engine runs on innovation: creative new firms continually arising to disrupt or destroy legacy firms. We say an economy is in a middle-income trap if the first stage engine fails to disengage.

Rapid catch-up growth populates business groups with firms built around off-the-shelf technologies. To these, innovation is a threat. If the external network rollout is complete, upstart innovative firms can form and rain creative destruction down upon the business groups that built the networks that let new firms form.

This fate is avoidable. Business groups loomed over rapid catch-up development in late 19th and early 20th century Latin America. Argentina's rapid early industrialization, popularized in the musical Don't Cry For Me Argentine - is perhaps best known. However, other Latin American economies also attracted huge capital inflows and successfully established constellations of big businesses, each a member of one or another business group.

The rollout of the network can be stopped part way through. New innovative upstart corporations can be overcharged for inputs and underpaid for outputs if established firms in those sectors deal preferentially with other firms in their business groups. Upstarts can find capital expensive if existing banks and securities underwriters belong to business groups. Upstarts can find regulators and courts unhelpful if an incomplete network rollout leaves the government an insufficient tax base to finance these public services.

Close ties between government officials and business group controlling shareholders can solidify

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[2] Morck & Yeung (2003)

a so-called limited access order, where an elite can access such government services, with others consigned to an informal economy.[3] Middle-income trap economies thus contain a handful of business groups, each containing large legacy corporations, and countless informal small businesses – roadside tea stands, tiny illegal shops, and the like. Business groups find salvation, but ascent to high-incomes is sacrificed.

Corporate Governance for Second Stage Growth

Once each business group establishes its network, its corporations gain value from positive network externalities. At this point, economies that ascend to high-income status somehow switch towards corporate governance and away from business group governance.[4] This lets upstart innovative firms form and the economy switch engines to ignite growth by creative destruction.

One way to switch engines is to dismantle the business groups. The United States dismantled its business groups during the Great Depression.[5] With unemployment at 25% and industrial production down 40%., business elites were vulnerable. Academics in President Franklin D. Roosevelt's "Brain Trust" condemned business groups' controlling shareholders for putting their private gains ahead of general prosperity.[6] Progressive reformers debated whether corporate governance ought to advance the interests of small shareholders or a broader range of corporate stakeholders,[7] but neither side favored business groups.

The New Deal attach on business groups included the 1933 Glass-Steagall Act, which severed the Morgan Bank from its pyramidal group, the largest and most diversified in the country. The 1933 Public Utilities Holding Companies Act banned large business groups from public utility sectors. Successive Income Tax Acts imposed and raised intercorporate dividend taxes, rendering corporations owning shares in other corporations increasingly tax disadvantaged. The 1940 Investment Companies Act imposed regulation as mutual funds on corporations whose assets are primarily shares of other corporations. The very concept of business groups was soon lost to American law schools, business schools and economics departments.

Unlike the US, high-income Europe retained large business groups through the 20th century. One factor may have been the post-World War II rebuilding of destroyed cities, industries, and infrastructure. Business groups played key roles in heavily state-subsidized reconstruction programs that sustained high growth, albeit from low starting points, for three decades – *les Trente Glorieuse* (the Glorious Thirty) in France, *Wirtschaftswunderjahren* (Economic Wonder Years) in West Germany, *il Boom Economico* (Economic Boom) in Italy, and *Rekordåren* (Record Years) in neutral Sweden, whose undamaged firms supplied reconstruction elsewhere.[8] Postwar reconstruction requires no innovation for the ruins of prewar structures serve as blueprints. Reconstruction ended in the 1970s, as expanding and deepening openness exposed each country's business groups to stiffening market forces. Business groups began splintering.

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[3] North, Wallis, & Weingast (2009)

[4] See the chapters in Colpan and Hikino (2018a), esp. Colpain and Hikino (2018b).

[5] Kandel, Kosenko, Morck, & Yafeh (2019)

[6] Berle & Means, (1932); Bonbright & Means (1932)

[7] Dodd Jr (1931)

[8] Eichengreen & Ritschl (2009); Jánossy (1969); Vonyó (2008)

Controlling families retained only key choice group firms. Corporations in surviving business groups took to innovating, but in sectors unimportant to legacy group firms,[9] presumably to avoid creative self-destruction.[10] Business groups diminished in importance,[11] perhaps as creative firms in one group disrupt uncreative firms in other groups, or as freestanding creative firms rise.

Australia and Canada, like Europe, let old business groups fade away.[12] Business groups arose in both amid late 19th and early 20th century rapid industrialization; mostly fell away spontaneously as the 20th century progressed. Equity-financed growth and takeovers likely eroded control blocks, leaving the managers of individual corporations under increasing pressure to maximize share valuations to avoid takeover bids. Groups resurged in the 1970s in both countries amid largescale industrial policy subsidy programs; and then fell away after those programs ended.[13] Parallels arise with Sweden, whose Social Democratic officials favored business groups because they liked dealing with "big business" via a few phone calls.[14] Throughout, in both countries, the CEO and board owed a duty to the corporation.[15]

Israel and Japan emulated the United States with explicit legislation to break up business groups. Japan's business groups built Asia's first industrial economy by the 1920s.[16] Japan was a US military protectorate from 1945 to 1952, and Americans recently finished dismantling US groups did likewise in Japan. By the 1952 US withdrawal, big businesses were freestanding widely held professionally managed firms, as in the US. To block 1950s and 1960s waves of control challenges, former business group firms placed small blocks of new shares with each other. Each firm more than doubled its market capitalization, placed a majority of its shares in pro-management hands, and received sufficient dividends from other group firms to pay the dividends it owed other group firms. These keiretsu were a new unique of business group, with no family or tycoon atop. Keiretsu firms participated in a heavily subsidized postwar reconstruction industrial policy that lasted into the 1970s. However, Japan's highest profile innovators – Honda, Panasonic, Sony, Toyota, etc. – arose outside the keiretsu. Keiretsu firms fell behind, despite bailouts, many now deemed zombie firms and blamed for lagging economic growth.[17] Keiretsu business groups increasingly seem relics of another era and a policy problem.[18]

Israel dismantled its business groups in the early 21st century.[19] Business groups run by the state-affiliated Jewish Agency of the World Zionist Federation, labor union alliance Histadrut, and a handful of business families with foreign financing rapidly built an economy after the country's

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[9] Belenzon and Berkovitz (2010)

[10] Morck and Yeung (2003)

[11] Colpan & Hikino (2018)

[12] Morck, Percy, Tian, & Yeung (2005); Morck & Tian, (2017); Ville, (2018).

[13] Morck, Percy, Tian, & Yeung (2005); Morck & Tian, (2017); Morck, Stangeland, & Yeung (2000); Ville (2018)

[14] Hogfeldt (2005)

[15] Canada's Oppression Remedy has business group-level reach, but grants shareholders of a group firm standing to sue the controlling shareholder for tunneling, even if this benefits other group firms. Group firms must be run independently. Supreme Court rulings People's v. Wise [2004 SCC 68] and BCE Inc. [2008 SCC 69] infer analogous stakeholder rights.

[16] Morck and Nakamura (2005).

[17] Caballero, Hoshi, & Kashyap (2008); Dow & McGuire (2009)

[18] El Kalak & Yamada (2018)

[19] Kosenko & Yafeh (2010)

1949 independence. Family business groups took up corporations shed by the Jewish Agency and Histadrut and developed complicated pyramidal structures.[20] Group firms especially dominated finance. This concentration of economic and political power became a public policy issue.[21] A first reform mandated the unification of dual class shares upon any seasoned issue. Dual class shares - super-voting shares for insiders and ordinary shares for others – can hold business groups together with very small intercorporate equity blocks,[22] and this checked group expansions.[23] Business groups largely fell away after a 2013 reform banning pyramids of over two tiers.[24]

Latin America's Second Stage Failure to Engage

Many Latin American countries made substantial progress towards industrialization in the late 19th and early 20th century,[25] often capitalized by London-based business groups [26] Argentina, Australia and Canada seemed equally promising,[27] but Latin American development stalled and even reversed.[28]

Nationalism was one factor. British merchant houses organized business groups in the region around the turn of the 20th century,[29] but ceded control to local elites.[30] Often with roots in extractive colonial economies[31] or Napoleonic Era independence movements against French-controlled Iberia,[32] a handful of families came to control each country's pyramidal *grupos económicos*.[33]

Elite capture of national institutions was perhaps inevitable.[34] Latin America may exemplify early industrialization enriching a first generation of business families, whose heirs' political rent-seeking stalls further development that might disrupt a *status quo* favorable to them,[35] in part by effecting financial reversals, shrinking their economies' financial systems to deny potential competitors capital.[36]

Import substitution is a third factor. Argentine economist Raoul Prebisch argued multinational corporations (MNCs) bought commodities in developing economies at low monopsony prices and sold manufactured goods in developing economies at high monopoly prices. His solution was trade barriers to block both practices and massive subsidies to help domestic firms substitute for

[20] Kosenko (2007)
[21] Bebchuk (2012)
[22] Hauser & Lauterbach (2004); Lauterbach & Pajuste (2015)
[23] Lauterbach & Yafeh (2011)
[24] Hamdani, Kosenko, & Yafeh (2020)
[25] Haber (2006)
[26] Miller (1995)
[27] Di, Platt, & Pacini-Ketchabaw (1985)
[28] Haber, (1997); Edwards, (2010); Edwards, Esquivel, & Márquez (2007)
[29] Miller (1995); Di, Platt, & Pacini-Ketchabaw (1985)
[30] Leff (1978)
[31] Acemoglu, Johnson, & Robinson (2001)
[32] Gott (2007)
[33] Schneider, Colpan, & Wong (2018)
[34] Krasner (1984); North, Wallis, & Weingast (2009); Thelen, (1999); Goldstone (1998); Pierson, (2000)
[35] Rajan & Zingales (2004)
[36] Rajan & Zingales (2003)

MNCs.[37] Import substitution proved a hothouse for business groups[38]. Close-knit cartels, protected by trade barriers and subsidized by governments, kept prices high and made innovation superfluous to profits. Some monopolies were even state orchestrated, such as that of the privatized Mexican telephone monopoly Telmex, in the 1990s.[39] To avoid disruption, foreign technology entered via joint ventures between multinationals and local partner, typically group firms.[40]

Another factor is Corporatism.[41] The Great Depression discredited free-markets, and Falangist Spain and Estado Novo Portugal offered a church-sanctified alternative: Corporatism. Corporatism replaced markets with supply, cost, price, and entry management by Associations of business owners, clergy, labor leaders, and officials. Each Association regulated one of thirty or so a vertically connected sets of industries. The controlling families of large business groups often had representation in the Associations governing multiple industries. Corporatism, spread across the region in the mid-20th century, often after military coups legitimized by implementing Catholic social doctrine. Like import substitution, corporatism fertilized business groups.

Latin American remain dominated by handfuls of family business groups.[42] Market reforms in the 1980s and 1990s proved ephemeral.[43] At the advent of the 21st century, a handful of families controlled great Argentine firms, a third founders' children, a third their grandchildren, and a third their great grandchildren.[44] MNCs and domestic business groups arguably impeded movement towards both markets in corporate governance and coordination in inter-firm relations throughout Latin America.[45]

Escape in Progress

Under General Park Chung-hee, South Korea rose to middle-income levels in the 1960s and 1970s, as large family business groups (*chaebol*) formed and expanded. By 1979, Park's subsidies to the chaebol had bankrupted the government.[46] Park decided to end business subsidies and was assassinated before the decision was announced. In 1980, General Chun Doo-hwan took over a bankrupt state shut out of sovereign debt markets. To obtain an international bailout, as a last resort, all other options exhausted, Chun grudgingly adopted free-market economics and ended subsidies business.

The chaebol pyramids sprouted new member firms, and GDP rose faster than wages. Widespread strikes and student protests brought in democracy in 1987. Wages rose rapidly, approaching First World levels by the mid-1990s, creating a large domestic market that more

[37] Prebisch (1950)
[38] Hoshino (2010)
[39] Doh (2000)
[40] Schneider (2009 p. 565)
[41] Morck and Yeung (2010)
[42] Aldrighi & Postali, (2010); Fracchia, Mesquita, & Quiroga (2010); Hoshino (2010); Khanna & Palepu, (2000); Khanna & Yafeh, (2005); Lefort, (2010); Miller, (2010).
[43] Schneider (2008).
[44] Fracchia, Mesquita, & Quiroga (2010)
[45] Schneider (2009, p. 565)
[46] Chibber, (1999, 2005); Luedde-Neurath, (1986)

than replaced falling exports[47] as the chaebol expanded,[48] and productivity surged.[49]

Even before the 1997 crisis, the chaebols' dominance was a political concern. [50] Business groups made sense when markets, contracts, and trust were weak; but increasingly seemed economic relics.[51] Chaebol heirs' financial and corruption scandals evoked "too big to jail" concerns [52] One scandal jailed President Park Geun-Hye (General Park's daughter) and Lee Jae Yong (the Samsung heir). Lee alone swiftly obtained release.[53] Calls to dismantle the chaebol continue.

Disengaging Business Group Governance, Engaging Corporate Governance

Corporate governance displaces business group governance in high-income economies, whose ongoing prosperity depends on continual innovation. Creative firms unfold new technologies to maximize their profits without regard to the disruption of legacy firms. Business groups, replete with legacy firms, balance innovation against disruption without weighing in the economy-level benefits of rapid sustained innovation.

Corporate governance displaces business group governance in open, free market economies with active equity markets and markets for corporate control. Banks in Australia, Britain and Canada historically provided trade credit, rather than long-term loans for corporate expansion, so firms needed to issue shares to grow. Large continued share issues dilute control blocks, leaving group firms increasingly vulnerable to takeovers. Group firms that do not maximize profits are takeover targets, and acquirers issue shares to finance the takeovers, diluting their own control blocks.

Economic openness can help corporate governance displace business group governance. Deepening European economic integration and European bilateral and multilateral trade and capital barrier reductions opened foreign networks to upstart local firms. Openness, entirely aside from its benefits in traditional trade models, may facilitate growth through innovation by reducing the power of domestic legacy firms' (and business groups) to hinder incumbents.

Breaking business groups up leaves only corporate governance on the table. The United States did this as part of its New Deal, an unprecedentedly sweeping Depression era of trade barriers and state intervention. New Dealers in Japan's postwar US military government then broke its business groups up. Israel enacted legislation to break its business groups up in the early 21st century. In all three cases, legislative attacks on business groups took place amid deep public anger at business elites, and such an approach may not be feasible where business groups' lobbying remains influential

Business group governance can be preserved by measures that work opposite to all the above. Small stock markets dominated by legacy firms can limit upstarts' access to capital and preserve control blocks in legacy business groups with banks as member firms. Industrial policies that sideline market forces and prioritize access to subsidies and regulatory favors reenergized

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[47] Mo & Weingast (2013)

[48] Kim, Ryou, & Takagi (2010); Almeida, Kim, & Kim (2015)

[49] Young (1995) shows prior work overstates factor accumulation in South Korea*n* productivity growth.

[50] Lim & Hahm (2006)

[51] Bai, Kang, & Jin-Mo (2002); Lee, Park, & Shin (2009); Oh (2017)

[52] Choi, Hyoung-Goo, & Lee (2018); Oh, (2017)

[53] Samsung Heir Is Indicted but Avoids Jail, *New York Times*, Sep 1, 2020.

business groups in European and Japanese postwar reconstruction and in Australian and Canadian. Generations of Corporatist industrial policy across Latin America may explain that region's venerable business groups and generations-long middle-income status. The region's embrace of import substitution cut off local upstarts' access to foreign business partners and capital, reinforcing the power of legacy firms to block disruptive innovators.

Other factors may also matter. Higher income countries tend to have better schools, more democratic government, and more open and competitive economies. Cultures valuing individualism, egalitarianism, and rationality might also encourage innovation and discourage acquiescence to legacy hierarchies. The direction of causation is worth investigating.

Conclusions

Economic development is obviously far more complicated than the stylized stages described is this chapter and the prior one. They fit the development trajectories of some economies better than others, and miss much. The rise of large highly diversified business groups amid catch-up development and their falling away in high-income economies, though not universal, is commonplace enough to invite explanation.

We posit that business group governance arises amid rapid catch-up development, subsuming corporate governance, to contend with pervasive network externality problems. Rapid catch-up growth arises as business groups establish networks of interdependent corporations, each generating positive network externalities for the others. We posit that corporate governance then replaces business group governance because "every corporation for itself" governance better facilitates the creative destruction that powers high-income prosperity. Finally, we posit that a middle-income trap can arise, wherein entrenched large business group governance and network incompleteness reinforce each other.

Business history and economic development are both obviously far more complicated. However, our propositions do explain the prominence of large diversified business group governance in rapid catch-up industrializations, the greater policy importance accorded corporate governance in high-income economies, and the longstanding prominence of business group governance in economies that underwent a burst of rapid catch-up industrialization and then lingered at middle-income levels – some for generations. There are exceptions, and each country is different. We welcome alternative explanations.

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