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Corporate Governance versus Business Group Governance (Part 1: The Low-income Trap)

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Abstract

Every firm in a high-income market economy relies on the mere existence of countless other firms to keep prices competitive throughout densely interconnected supply chains. Without this network externality, no firm forms; and without many firms, no network forms. Escaping this low-income trap is a primary problem in launching rapid catch-up development. Business group governance supersedes corporate governance in catch-up development, today and historically. Business groups can roll out new firms and expand existing firms in the interests of the group as a whole, and are thus a uniquely advantageous governance structure for rapid catch-up economic development

Keywords: Low-income trap, network externality, business group governance, corporate governance, big push

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Introduction

In a high-income economy, each firm depends on suppliers and customers, suppliers' suppliers and other customers, customers' customers and other suppliers, etc. All these depend on the existence of enough competitors through these product chains to keep all the other firms' prices in line. Every firm depends on all firms' well-paid employees buying consumer goods. All the above depend on governments raising enough tax revenue to educate the employees to justify their high wages, and so on. The lone steel mill in an otherwise subsistence economy is doomed. The steel mill surrounded by this network can be viable. This is the low-income trap: without this network, no firm forms; without firms, no network forms.

Escape

Britain, the first escapee, took generations of slow and uneven growth to escape this trap. Other countries caught up fast. Belgium pioneered the business group, which subjects many firms, each with its own managers and shareholders, to coordinated governance. In economy after economy, business group governance preceding or superseding corporate governance provides an escape from this low-income trap¹.

Large business groups are generally pyramidal. An apex firm, usually controlled by a tycoon or business family, controls a first tier of subsidiaries, each of which controls firms in a second tier, each of which controls firms in the next tier down.² Firms throughout can issue shares as long as the immediate parent firm retains control, so a pyramidal group can mobilize vast equity financing while preserving effective business group governance.

Business group governance prevents group firms from holding each other up or otherwise cheating each other. For example, a country's sole railroad can hold-up its lone steel mill with exorbitant freight rates that eat away all profits or let unsold inventory pile up. A fully rolled out network would let cheated firms take their business elsewhere; efficient government regulation and courts would let it seek judicial redress.³ Otherwise, hold-ups are at every turn, firms do not form, and the low-income trap prevails.⁴

Business group governance forces group companies to deal fairly with each other, lets specialized firms populate the nodes of interconnected product chains, each raising risk-tolerant equity financing. Business groups can acquire reputations for fair dealing that can make their member firms preferential suppliers and customers for independent firms, preferential employers for skilled workers, and preferential issuers of shares in otherwise fraud-prone markets.⁵ The advent of business group governance thus unlocks the low-income trap.⁶

In many economies, most large listed companies belong to one of a handful of business groups. The stock exchange may show many listed firms, but corporate governance can be relatively

¹ See the chapters in Colpin and Hikino (2018a), esp. Colpan and Hikino (2018b).

² La Porta, Lopez-de-Silanes, & Shleifer (1998); Masulis, Pham, & Zein (2015)

³ Felli & Roberts, (2016); Haggard, MacIntyre, & Tiede (2008)

⁴ Dincer & Uslaner, (2010); Farah & Hook, (2017); La Porta, Lopez-de-Silanes, Shleifer, & Vishny (1997). Klein, Crawford, & Alchian (1978); Williamson, (1975)

⁵ Khanna and Yafeh (2007)

⁶ Morck, (2009, 2011); Morck & Nakamura, (2007)

unimportant. Corporate boards and CEOs are subordinates; business group governance is what matters.

The low-income trap

Low-income economies consist of uncounted informal businesses, subsistence agriculture, roadside tea stands, streetside vendors selling goods laid out on benches or blankets, and the like - plus a handful of large state-owned or politically-connected big businesses.⁷ Rapid development requires transcending this low-income trap, identified in 1943 by Paul Rosenstein-Rodan and subsequently elaborated.⁸

The low-income trap is a *network externality* problem. An *externality* is a market failure that arises when one actor's decisions affect others. A corporation profiting by polluting negatively affects people downwind - a negative externality. Another profiting from a vaccine prevents an epidemic - a positive externality to the unvaccinated. Externalities are market failures because free markets overproduce things with negative externalities and underproduce things with positive externalities.

Network externalities are externalities whose importance increases as a network expands.⁹ The telephone has positive network externalities because owning the only one is pointless, but owning one is increasingly useful as more people get phones. The value of one's phone depends on the interacting actions of others. The larger the telephone network, the larger the positive network externality.

A developed free market economy is a network with huge positive externalities. A factory's value in a high-income economy minus its value in a subsistence economy is the positive network externality value to that factory.

This highlights a core problem with transplanting high-income economy concepts of good corporate governance into low-income economies. Milton Friedman defined good corporate governance

"There is one and only one social responsibility of business to use its resources and engage in activities designed to increase its profits so long as it stays in the rules of the game, which is to say, engages in open and free competition, without deception or fraud."¹⁰

Good corporate governance so-defined creates yet another market failure, hold-up problems.¹¹ A first-mover, say an entrepreneur who founds a firm in a subsistence economy might hope to inspire an essential supplier to set up shop too. However, the first mover is at a disadvantage because a well-governed profit-maximizing supplier can demand an up-front payment, equal to almost all the first mover's expected profits, before setting up. The first mover can either turn over the money or go bankrupt. The first mover needs multiple suppliers and customers, and each can play this hold-up game. Rationally expecting all this, prospective first movers never

⁷ La Porta, Lopez-de-Silanes, Shleifer, & Vishny (1997)

⁸ Rosenstein -Rodan (1943); Murphy, Shleifer, & Vishny (1989)

⁹ Liebowitz & Margolis, (1994)

¹⁰ Friedman, (1970)

¹¹ Coase (1937); Hart, (2009, 2017); Holmstrom & Roberts, (1998); Williamson, (1986)

move. Good corporate governance strangles economic development.

Foiled escapes

Rosenstein-Rodan saw multilateral institutions channeling aid from high- to low-income economy governments to subsidize a Big Push – the state-coordinated rollout of the entire network. In the mid-20th century, the World Bank and other multilateral organizations poured vast aid into low-income economy governments.

Yet by the 1980s, few low-income economies had industrialized. Aid inflow, if anything, correlated negatively with growth and positively with corruption. Political economy chimes in: Making subsidies firms' main source of profits makes political connection-building their most profitable investment.¹²

Aid-financed Big Push programs establish firms, but hold-up problems can persist in a sparse network. A firm or group of firms with market power at any node in the network can hold-up all the others. Big Push aid appears to worsen this problem. The “rules of the game” Friedman mentions - well-crafted and well-enforced laws and regulations – are expensive and malleable. Low-income economies have little economic activity to tax.¹³ More aid earmarked for subsidies makes reshaping the rules of the game to capture subsidies more profitable. Lobbying to increase profits within “the rules of the game,” is surely good corporate governance. Earmarking later aid for schools or clinics can be difficult once channels to businesses are deep, and aid so earmarked no longer addresses directly the network externality problem of the low-income trap. Big Push policies entrenched corruption, distorted the “rules of the game” and locked in the low-income trap.¹⁴

Fast Escape is Possible

Belgium pioneered an escape of the low-income trap, and became Europe's most industrialized country by the 1840s.¹⁵ Belgium established private-sector state-championed industrial development banks, Société Générale (SG) and Banque de Belgique being paramount, to organize, finance, and provide margin financing for the outside shareholders of some 151 manufacturing companies in diverse sectors in the 1830s.¹⁶ Financial crises in the late 1830s and late 1840s bankrupted many of these, and the banks seized their physical assets.¹⁷ Rather than auctioning these assets off, the banks reorganized them as controlled subsidiaries. Over time, the subsidiaries needed capital and the banks underwrote their securities issuances.¹⁸ Business groups formed, each of a bank controlling equity blocks in many companies, each with its managers and other shareholders, in different industries.

¹² Baumol, (1990) Bhagwati, (2005); Djankov, Montalvo, e& Reynal-Querol (2008); Easterly, (2003)

¹³ Besley & Persson, (2014)

¹⁴ Easterly, (2005, 2006a, 2006b). Nuances in corporate governance likely played very little role. Firms maximized profits because their owners, politically connected tycoons and business families, wanted money. If anything, corruption grew worse in low-income economies with Napoleonic Code legal systems, more amenable to stakeholder rights (Beck, Levine, & Demirgüç-Kunt, 2002)

¹⁵ Becht, (2018); Mokyr, (2018)

¹⁶ Van Nieuwerburgh, Buelens, & Cuyvers (2006)

¹⁷ Daems (1977)

¹⁸ Becht (2018)

The banks oversaw multiple specialized companies, rather than a single widely diversified conglomerate. A form of limited liability meant separate companies provided bankruptcy firewalls.¹⁹ Separate companies, each with its own accounting records, share price, and responsible top executives may also have simplified the bank's monitoring and control costs by outsourcing these tasks to markets.²⁰ Industrially focused firms are more readily monitored and hence more valued by outside shareholders.²¹ The business groups expanded in step with Belgian financial development, suggesting external financing.²²

The controlling bank could order firms in its group to forego holding each other up, skimping on quality, or otherwise extracting profits from each other. Foregoing profits legally obtainable is poor corporate governance: it does not maximize profits subject to the rules of the game. Nevertheless, preventing such behavior is good business group governance because it lets commerce and investment expand between firms in a network within the group, to the benefit of them all and to the economy. We posit Belgium's pioneering invention of the business group explains its early and rapid industrialization.

The Belgian model was widely emulated, though business groups elsewhere often had a business family firm atop, rather than a bank. The Louis Dreyfus & Co, Rothschild Frères and Paribas (Banque de Paris et des Pays-Bas) groups oversaw French industrialization²³. Business families and banks led Sweden's business groups.²⁴ The importance of banks and families to Germany's industrialization is debated, but business groups were important.²⁵ Business groups also arose in Italy,²⁶ Spain²⁷ and Portugal.²⁸ In each, the coordinated governance of groups of corporations loomed large.

Assisted Escapes

Britain pioneered industrialization. Indeed, Belgian business group firm appropriated British technology. However, Britain's industrialization took centuries, with annual growth rarely exceeding two percent. Business groups are not evident, and British companies appear chronically capital constrained.²⁹ Government war debt crowded out business borrowing until well into the 18th century. The Bubble Act of 1720 restricted chartered joint stock companies until 1825, so unchartered jointly owned businesses arose and issued shares. Shareholders had unlimited joint liability until a series of reforms from 1855 to 1862, thereafter shareholder liability was limited to par value (generally greater than the share price). Limited shareholder liability in the modern sense became prevalent only in the 1890s. Until then, shareholders needed deep pockets.

¹⁹ Van Nieuwerburgh, Buelens, & Cuyvers (2006); Hansmann, Kraakman, & Squire (2006)

²⁰ Dau, Morck, & Yeung, (2020)

²¹ Maksimovic & Phillips, (2007)

²² Van Nieuwerburgh, Buelens, & Cuyvers (2006)

²³ Cassis (2018)

²⁴ Hogfeldt (2005); Larsson & Petersson (2018)

²⁵ Fohlin (2005); Schröter (2018)

²⁶ Colli & Vasta (2018)

²⁷ Cuervo-Cazurra (2018)

²⁸ Silva & Neves (2018)

²⁹ Jones (2018); Williamson (1984)

Businesses were proprietorships, partnerships or unchartered companies. A legal presumption that companies ought not to own other companies' shares deterred business groups until 1867, when intercorporate share ownership became legal.³⁰ However, the shareholders of companies connected via intercorporate share ownership or common controlling owners were potentially jointly and severally liable until 1893, when the House of Lords decreed they were not. Until then, shareholder in business group firms needed deeper pockets.

Business groups were not evident. Hold-up problems were limited only by norms of "gentlemanly" behavior, for courts provided scant redress.³¹ Britain's low-income trap escape was slow, protracted, and difficult.

Business groups begin appearing towards the end of the 19th century, after Britain's industrial revolution was largely history.³² Equity markets had arisen. Industrialization had created wealthy heirs with family trusts. Trusts, unlike companies, could own shares in companies.

In the 1890s, merchant banks took to organizing London holding companies as trusts whose assets were business groups in then-emerging economies.³³ For example, the London listed Matheson and Co. pumped London capital into China. Matheson group firms included China Coast Steam Navigation, Indo-China Steam Navigation, Shanghai-Woosung Railway, China Railway, Canton Insurance, Ewo Bank of Shanghai, Rio Tinto Mines, Transvaal Exploration, Caucasus Copper and, through Jardine, Matheson and Co. in Hong Kong, China Sugar, Hong Kong Land, and Ewo Spinning.³⁴

London-based business groups played major roles in the late 19th and early 20th century industrializations of British colonies and dominions and in the Latin American republics.³⁵ British legal residencies may have mitigated risk that would otherwise have deterred their investors, customers, suppliers, managers and employees. Capital flowed in vast quantities from capital-intensive Britain to labor-intensive economies throughout the world.³⁶

Britain's Largest Ex-colony

American business groups followed a unique trajectory.³⁷ American Common Law retained the British presumption that companies had no business owning shares in other companies until 1891. As in Britain, trusts proliferated. Using trusts, John Pierpont Morgan built an industrially diversified business group around the Morgan Bank that may have provided network externalities in late 19th century US industrialization.³⁸ However, these trusts were also widely condemned for holding up independent business.³⁹

³⁰ Brice (1880, p. 92).

³¹ Mokyr (2010)

³² Jones (2000; 2018)

³³ Jones (2018); Jones & Colpan, (2010)

³⁴ Chapman (1985, pp. 230-51)

³⁵ Fracchia, Mesquita, & Quiroga (2010); Miller (1995). Paris merchant houses organized like groups with apex firms listed in Paris an operating companies in French colonies (Cassis 2018)

³⁶ Jones & Colpan (2010)

³⁷ Collis, Anand, & Cheng (2018); Hikino & Bucheli, (2018); Kandel, Kosenko, Morck, & Yafeh (2019)

³⁸ Chernow (2010)

³⁹ E.g. Brandeis (1914)

By the 1880s, industrially focused trusts grew prominent and monopoly pricing attracted Progressive opprobrium. The 1890 Sherman Act allowed the breakup of monopolistic trusts.⁴⁰ In 1888 apparently reflecting a widespread view that the Sherman Act, then before Congress,⁴¹ would apply only to trusts, New Jersey legalized companies owning shares in other companies.⁴² This offered trusts the option of restructuring into pyramidal business groups, and increasing numbers did so. Other states raced to allow business groups too. By the 1920s, business group member firms dominated the New York Stock exchange. A spate of New Deal legislation broke up American business groups and its Chandlerian⁴³ freestanding widely held professionally managed big businesses were in place by 1950.

An Asian escape⁴⁴

Japan had shut out foreign contact for centuries when Admiral Perry's US gunboats steamed into Tokyo harbor in 1853, overwhelming and dishonoring the Tokugawa Shogun. Young samurai warriors seized power in the name of the figurehead Meiji Emperor. The Meiji Restoration government, to modernize the military, sent students abroad to study foreign technologies. These returned with alarming news of Japan's poverty and backwardness. In a comprehensive institutional reboot, Japan adopted a Scottish banking system, British navy, German law code, American free press, Prussian constitution, French compulsory public schools and what seemed global best practice institutions across the board.

Getting foreign technologies up and running did not interest Japan's merchant families, members of a social caste despised by samurai warriors. The Meiji government therefore created legions of state owned enterprises (SOEs) in the 1860s and 1870s. Japan then had considerable mineral wealth, and mining SOEs were to subsidize industrial SOEs until all were self-sustaining.⁴⁵ Soft budget constraints⁴⁶ let the SOEs, including mining companies, bleed money. The government borrowed domestically and in London, printed money, and, after suppressing a costly samurai rebellion, confronted a devastating financial crisis in 1879.

Finance Minister Matsukata cut the size of government, imposed comprehensive free market reforms, and undertook a mass privatization of SOEs. Officials were well paid and, under laissez-faire could deliver little for bribes. Corrupting officials appears to have been unprofitable.

Ex-SOEs' assets and talented employees passed to old merchant families – e.g. the Mitsui (silk) and Sumitomo (copper mining) – or new entrepreneurs – e.g. the founders of Mitsubishi and Nissan. This did what the state could not. Their mining firms' earnings funded firms in successively more industries. As these business groups (*zaibatsu*) expanded, wealth spread. Mine revenues fell, but the zaibatsu tapped stock markets to continue expanding until each of the largest had a firm in every major sectors.

⁴⁰ US antimonopoly law is still called Antitrust Law.

⁴¹ Grandy (1993)

⁴² Sherman Act was drafted in 1888, enacted in 1890, and upheld as Constitutional by the Supreme Court in 1911, whereafter trusts reorganized into business groups en masse (Kandel, Kosenko, Morck, & Yafeh, 2019)

⁴³ Chandler (1977)

⁴⁴ This section draws on R. Morck and Nakamura (2005; 2007)

⁴⁵ Morck and Nakamura (2018)

⁴⁶ Kornai (1986)

Banks in the Mitsui, Mitsubishi, Nissan, and Sumitomo zaibatsu specialized in trade credit. Only a few zaibatsu emulated Belgian, French or Swedish business groups in using their banks to finance the expansion and formation of other group firms. Group industrial development banks, called organ banks successfully financed the expansion of the Suzuki zaibatsu, but the high and interconnected debts of its member firms proved financially unstable. Zaibatsu with organ banks imploded in the global financial crisis of the early 1920s.⁴⁷ Organ banks came to be seen as poor business group governance.

The tycoons and families controlling these groups portrayed themselves as nation-builders, but were likely self-interested. The tycoons and business families that controlled the zaibatsu “cared more” about firms they owned directly than about those firms’ subsidiaries and subsidiaries’ subsidiaries.⁴⁸ Thus, Nissan’s founder, Yoshisuke Aikawa, ran the Nissan group to maximize shareholder value in the widely held firm at the apex of the Nissan zaibatsu to retain the support of its shareholders, and shunted funds in and out of other group firms to this end. The controlling shareholder shunting funds out of a firm, called tunneling, constitutes poor corporate governance.⁴⁹

However, using that money to finance a high value-added investment elsewhere in the business group can be deemed good business group governance and a step out of the low-income trap.⁵⁰ A controlling shareholder ordering a group member firm to forsake monopoly or monopsony profits from holding-up other group firms or to produce intermediate goods essential elsewhere in the group at a loss likewise constitutes poor corporate governance. However, in each case, the controlling shareholder’s actions might constitute good business group governance, defined as maximizing the value of the business group as a whole.

By the early 20th century, Japanese firms were major players in global trade.⁵¹ By the 1930s, Japan had become an industrial power able to wage war on Britain, China, France and Russia, if not on America.

A well-documented escape

The world’s newest large high-income economy is South Korea. Its ascent from sub-Saharan to European living standards in the 1970s, 1980s and 1990s is a uniquely well-documented demonstration of the importance of business groups.⁵² A deeper investigation of South Korea’s industrialization is therefore useful for building a general explanation of how business group governance, rather than corporate governance, provides an escape from the low-income trap.

Syngman Rhee, the first president and Woodrow Wilson’s student at Princeton, channeled massive US aid to subsidize nascent business groups, many with bank affiliates.⁵³ Despite rampant corruption and financial crises, Rhee kept US aid pouring into what seemed a dismaying

⁴⁷ Okazaki, Sawada, & Wang (2007)

⁴⁸ Morck & Nakamura 2(005, p. 386)

⁴⁹ Johnson, La Porta, Lopez-de-Silanes, & Shleifer (2000)

⁵⁰ Almeida, Park, Subrahmanyam, & Wolfenzon (2011; Almeida & Wolfenzon (2006)

⁵¹ Meissner & Tang (2017)

⁵² This section draws on Lim (2004); (Lim, 2013), Lim & Hahm (2006), and Lim & Morck (2020)

⁵³ Lim (2004); Haggard (1991); Lim (2003)

“foreign aid sinkhole”.⁵⁴ His indisputable positive legacy was universal basic education.⁵⁵ By Rhee ouster in 1960, living standards were no higher than in 1945. South Korea was deeply corrupt, profoundly poor and in a deep financial crisis.

General Park Chung-hee seized power in 1961 and won Rhee-era crony-capitalists’ support by staying corruption prosecutions, though he nationalized their banks. A Tokyo Military Academy alumnus, Park observed the role of business groups in Japan’s escape from the low-income trap and the demise of the Suzuki zaibatsu by its organ bank.⁵⁶ Park scorned officers and officials tainted by commerce, leaving corruption an unwise career move. He wanted economic development to end dependence on US aid, especially as the Vietnam War revealed US irresolution. To accumulate foreign exchange (essential for arms purchase) Park guaranteed exporters’ foreign debts. This imposed a market test (exports had to be competitive) and a moral hazard (loan guarantees let business owners borrow aggressively abroad and tunnel money to their other firms). A 1969 foreign loan default crisis triggered bailouts, then a full-scale financial crisis.

Park switched tactics and lent directly to Heavy and Chemical Industries (HCI) firms, all militarily important. Alert to moral hazards, he demanded that HCI loan recipients issue equity, and business groups (*chaebol*) formed as pyramidal structures. As in Belgium, pyramiding mobilized equity capital on a large scale, yet the chaebol family control each firm by dint of controlling its parent. Park accepted chaebol families tunneling wealth from subsidized HCI firms to frivolous undertakings in electronics and automobiles as a cost of dealing with merchants.⁵⁷

The coordinated sprouting of new firms illustrates how business group governance sidestepped the low-income trap. Koo Cha-Kyung⁵⁸ details how his family’s LG chaebol expanded:

“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 soapboxes. 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.”

Each new firm formed to provide a business partner existing firms needed, overcoming Rosenstein-Rodan’s network externality problem. By 1980s, each of the largest chaebol had “full set diversification” – one firm in each major industry.

⁵⁴ Chapin (1969)

⁵⁵ Azariadis & Drazen, (1990); Seth (2002)

⁵⁶ Lim, (2004); Lim (2003)

⁵⁷ Hundt (2008, p. 68)

⁵⁸ Aguilar & Cho (1985)

Koo is unclear as to the importance export promotion and HCI Drive subsidies to LG's expansion. Subsidies likely entered at multiple points, but a state-led Big Push is hard to discern. Rhee's subsidies were money-for-loyalty crony capitalism. Park's export promotion and HCI subsidies focused narrowly on a few key sectors, leaving others to sink or swim. The chaebol may have tunneled subsidies from firms in targeted sectors to firms in other sectors. The chaebol families, not state technocrats, coordinated the establishments and expansions of firms across sectors. Indeed, by 1979, when HCI Drive subsidies precipitated another crisis, many thought the *chaebol* families were coordinating the state.⁵⁹

Good Business Group Governance

The economic histories above suggest that low-income trap economies can achieve rapid catch-up growth by letting business group governance subsume corporate governance. Business groups can coordinate the rollout of the network of interdependent firms that, ultimately, can become a free market economy

Much as Soviet factories remitted earnings to Moscow for reallocation under Five-year Plans, zaibatsu firms remitted earnings to the apex firm for reallocation to fund technology, investment, or wherever the group needed.⁶⁰ Each business group was thus an industrially diversified centrally planned economy within Japan's Victorian classical liberal economy. The Soviet system is a historical failure and business group controlling shareholders are unlikely to be less self-interested than commissars. However, the rapid catch-up of Japan, Korea and others links business group governance to escaping the low-income trap. We posit that good business group governance be defined as what it takes to escape this trap. Specifically,

Business group governance displaces corporate governance. Decision-making in the Japanese zaibatsu was unambiguously at the business group-level, not the corporation-level. Good business group governance reallocated capital from firms with surplus earnings to finance other firms' expansions and formations as needed by the group as a whole.⁶¹ Each corporation's earnings rose to the apex firm, which reallocated capital across group corporations. Each corporation's president and top managers accepted that their firm's profits might have to take a hit for the sake of the economy-spanning business group.⁶² Key decisions made at the business group level appears to be an overarching characteristic of business groups in economies passing through this state of development. Corporate presidents are servants to the family or tycoon.

Business groups internalize network externalities. By superseding corporate governance, business group governance captures network externalities, but keeps them internal to the business group. The business group can be said to internalize the network externalities. During rapid catch-up development, major business group expand across diverse sectors. This lets business groups handle internally transactions that, if done between independent profit maximizing firms, would trip the low-income trap. In some cases, business groups even expand sufficiently to invest in pure public goods, such as universities and transportation infrastructure,

⁵⁹ Luedde-Nerath (1986); Chibber (1999; 2005)

⁶⁰ Goto (1982); Aoki (1988, p 223)

⁶¹ Hasegawa (1938); Miyajima (2004)

⁶² Morikawa (1992, p. 105)

confident their member corporations would internalize much of the positive externalities of a more educated pool of employees.⁶³ The extent to which business groups elsewhere funded schools, hospitals, universities or other public goods providers is, as far as we know, unexplored. However, business groups' internalization of markets for intermediate goods appears to be a common feature across many countries.⁶⁴

Equity financed group member corporations. Japan's business groups expanded using equity financing. Most zaibatsu banks adopted Scottish merchant banking practices, using deposits to fund trade credit with readily sellable inventories as collateral. The ill-omened Suzuki group and others with organ banks that financed long-term loans with capital assets as collateral aside, Japanese business groups relied increasingly on equity finance to supplement intragroup earnings transfers as each expanded. Equity, rather than debt financing, may have made Japan's business groups less prone to the episodic financial crises and state bailouts that interrupted rapid industrialization elsewhere. Fully diversified shareholders, holding a value-weighted portfolio containing shares in every firm, would not have objected to tunneling that decreased the value of their shares in one group firm to increase the value of their shares in another by a greater amount. Something akin to this calculation also maximized the value of the group apex firms, whose assets were a diversified portfolio of shares in the other firms in the business group. If the weights of each business group member firm in the apex firm's portfolio were proportional to their weights in the diversified shareholders portfolio, maximizing the apex firm's value (the controlling shareholder's presumed objective) accords with maximizing the value of the group as a whole to public shareholders. Exact proportionality is unlikely, but even merely rough proportionality might help.

Competition between business groups. Each business group imposed central planning across its growing network of corporations. Unlike Soviet central planners, business group central planners had competition. Japan had several large economy-spanning business groups competing with each other for final customers and talented employees. Soviet inefficiency in the Sumitomo group would have sent customers and employees flying to the Mitsui, Mitsubishi, Nissan or Suzuki groups. The group with the most efficient central planning and least rapacious controlling shareholder could charge lower prices and pay higher wages, all else equal. Competitive central planning may have promoted economic efficiency. Degrees of competition between rival business groups are also evident in Korea, Europe, and British overseas business groups.

Small or non-corrupt government. Japan's Victorian classical liberal minimalist government, staffed with highly paid civil servants, was not prone to corruption. Park Chunghee's export promotion and heavy and chemicals industries interventions in 1960s and 1970s South Korea were narrowly targeted, leaving much of the economy to market forces; and corruption was minimal. Small government was the rule in Victorian Australia and Canada, in Latin America, and in the British colonies hosting London-based business groups. Corrupting officials is less profitable where officials have fewer subsidies to redirect, fewer regulations to skew, and worse consequences for being caught at ether.

⁶³ Major Turkish business groups fund universities. Japan's Mitsui group established Hitotsubashi University.

⁶⁴ Khanna and Yafeh (2007)

Openness. Japan was an open economy. Japan had reluctantly accepted so-called Unequal Treaties, which eliminated its trade and capital barriers. Simple physical distance from other industrialized and industrializing economies likely gave domestic producers a pricing advantage, but gross inefficiency would have lost customers to importers. Its business groups contained trading corporations, and imports could fill in missing links in product chains where transportation costs were not prohibitive.⁶⁵ Exporting also let corporations operate at efficient scales despite initially small domestic markets. Japan's openness, and the Victorian-era free trade, prevalent during the rapid catch-up industrializations of many of today's high-income economies, may have promoted good business group governance.

Conclusions

This chapter shows how replacing corporate governance with business group governance lets business groups internalize the network externalities of a free market economy. This makes business group governance a central issue in rapid catch-up economic development. However, every solution causes new problems. The next chapter shows how, once groups have established their network of firms, their roles are finished. Business group governance then gives way to corporate governance in economies that rise to high-income levels. Where business groups hang on, a middle-income trap snaps shut.

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