Discussion Paper No. 1

Corporate Governance and Family Control

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SPECIAL ISSUES RELATING TO CORPORATE GOVERNANCE AND FAMILY CONTROL

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The Global Corporate Governance Forum has commissioned a series of discussion papers that will help improve the understanding of corporate governance reform in developing countries. These papers discuss a number of issues raised by various regional corporate governance research network meetings organized by the Forum to support corporate governance research and policy discussion in developing countries. Comments on these papers are welcome and should be sent to the authors and copied to the Forum. The full series of discussion papers can be found on the Forums website.

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Abstract:

Control of corporate assets by wealthy family in economies lacking institutional integrity is common. It has negative implications on corporate governance and adverse macroeconomic effects when they extend across a sufficiently large part of the country' corporate sector. We consider the reasons why family control and control pyramids predominate in emerging market economies and in some developed economies, and also the reasons why widely held free standing firms predominate in the United States. We conclude by discussing policies countries might adopt to discourage family control pyramids, but caution that control pyramids are but one feature of an institutionally deficient economy. A concerted effort to improve a country's institutions is needed before diffuse ownership is desirable.

I. Introduction

Many countries entrust the governance of their large corporations on a handful of wealthy families. These families use control pyramids to effect these powers. We show that such control pyramids make firms vulnerable to a range of serious governance problems. We also argue that these problems can have adverse macroeconomic effects when they extend across a sufficiently large part of the country's corporate sector. We consider the reasons why family control and control pyramids predominate in emerging market economies and in some developed economies, and also the reasons why widely held free standing firms predominate in the United States. We conclude by discussing policies countries might adopt to discourage family control pyramids, but caution that control pyramids are but one feature of an institutionally deficient economy. A concerted effort to improve a country's institutions is needed before diffuse ownership is desirable.

II. What is a "Family Firm"?

Various studies come to different conclusions about the performance of family firms relative to that of other firms. To some extent, this is because they use the term "family firm" differently. Anderson and Reeb (2003) refer to any firm with a dominant shareholder as a family firm. By this definition, Microsoft is a family firm, even though Bill Gates has given no notice of any clear intention to pass control on to his sons or daughters. Likewise, their definition would catch Andrew Carnegie's turn of the century Carnegie Steel as a family firm, even though he ultimately sold out and gave the $480 million he received away to charities. Indeed, Carnegie's famous maxim "A man who dies rich dies disgraced" would be incomprehensible to the ruling families of multigenerational European family businesses.

In this study, we define family firm more narrowly to encompass only companies run by heirs of the people previously in charge or by families that are clearly in the process of transferring control to heirs.

This definition may seem incomplete in that it misses firms where the current controlling owner ends up founding a dynasty. Bill gates might leave Microsoft to his son, rather than endow universities and concert halls so as to die poor, like Andrew Carnegie. However, we believe that understating the importance of family firms, rather than overstating it, is the more judicious approach for the purposes of this study.

Many small businesses throughout the world are family firms. Small stores, carpentry shops, farms, and restaurants are often family affairs. Casual inspection of any shopping area in virtually any free market country shows that these businesses are important parts of the economy. These businesses are also not the focus of this paper. This is mainly because data on small businesses, unlike data on larger listed companies, is not publicly available. While survey data of various sorts has been compiled for small businesses in some countries, these data are, for the most part, not comparable from one country to another. It is to be hoped that this situation might change as more and smaller companies decide to list on stock markets, and begin publishing financial data. At present, however, we must pass by these firms.

Thus, this study examines large family firms – firms big enough to be listed, or run by families wealthy enough that their mercantile empires attract the notice of the world's financial press. In contrast, "family firms" do not include widely held firms, firms controlled by an entrepreneur/founder who is not in the process of transferring control to his blood descendents, and firms with large outside shareholders such as pension funds.

II. Basic Facts

This definition is sensible because we are interested in how the corporate governance of large family firms differs from that of other large firms. We are interested in this question because systematic differences in the governance of an economy's great corporations might affect its macroeconomic performance. This is a reasonable concern because the importance of family firms differs starkly across countries and across regions. Figure 1 shows the wealth of billionaires residing in a given economy as a fraction of gross domestic product.[1] Billionaire wealth is further divided into that of entrepreneur billionaires, who built up their own fortunes, and family billionaires, who inherited their wealth. In some regions, such as Australia, Israel, South Africa, and Southeast Asia, new money billionaire wealth is extensive. In Canada, India, Western Europe, and the United Kingdom, old family billionaire wealth seems dominant. New money and old family money vie for importance in Japan, Latin America, and the United States.

These differences in the sort of billionaires a country has are important because most countries entrust the corporate governance to a handful of very wealthy families. This is accomplished through the use of control pyramids. Since control pyramids are unknown in the United States and United Kingdom, economists trained in those countries are often unaware of the profound effects these structures have on both the control of a country's corporate sector and on political economy issues.

Figure 2 describes a stylized control pyramid. A family firm, at the apex of the pyramid, controls publicly traded firms, which then control other publicly traded firms, which then control yet other publicly traded firms. At each level of the pyramid, public shareholders contribute a minority equity stake. Control pyramids are ubiquitous outside the United States and United Kingdom. This has several key implications for corporate governance

1. Most companies in most countries have controlling shareholders – either wealthy families or other firms that, themselves, are controlled by wealthy families. This means that the managers of most firms in most countries serve at the pleasure of a wealthy family, not at the pleasure of public shareholders, as is the case in the United States and United Kingdom.[2]
2. Although the owner of the apex firm controls all the firms in the pyramid, her actual investment in the firms in the pyramid's lower tiers is often very small. For example, in Figure 2, a one million dollar decrease in the value of Firm F translates to a $510,000 (51% of $1,000,000) decrease in the value of Firm E, a $260,100 (51% of $510,000) decrease in the value of Firm D, a $132,651 (51% of $260,100) decrease in the value of Firm C, and so on. A million dollar hit on the value of Firm F ultimately translates into a fall of $17,596 in

[1] See Morck *et al.* (2000) for detailed definitions and a description of how the data are constructed.
[2] There is by now a huge literature on country's ownership structure, since the pioneer work in La Porta et al. (1999). Some recent work includes Attig, Gadhoum and Lang (2003), Faccio and Lang (2002), Claessens *et al.* (2000, 2002), Claessens and Fan (2003), and the papers cited there.

the value of the family firm at the apex of the pyramid. Thus, the ultimate controllers of Firm F have a real financial stake of only 1.76% in that firm.

3. A mere handful of wealthy families can control the greater part of a country's corporate sector. This is because pyramids let a family control corporate assets worth vastly more than its family wealth. To see this, return to Figure 2. Suppose the family firm at the apex is worth a mere billion dollars. If the pyramid contains two A level firms worth a billion dollars each, four B level firms worth the same each, eight C level firms, and so on, the pyramid shown in Figure 2 contains 127 firms, each on paper worth one billion dollars. The control pyramid thus leverages a billion dollars of family wealth into control over forms with book values totaling $127 billion. There is much double counting in this, for the assets of a firm in one tier consist mainly of stock in the firms in the tier below. However, even if we assume that only the firms in the F tier of the pyramid contain actual physical assets, this still ads up to $64 billion. Thus, by permitting control pyramids, most countries entrust the governance of their corporate sectors to a few leading families. Since the most able member of any single family is likely to be less able than the most able member of the broader population, this means that governance is ultimately not entrusted to the most able people in the country.

This situation contrasts starkly with the United States and United Kingdom, where most large firms are widely held and all large firms are free standing entities. They are widely held in that they have no dominant shareholder. Insiders often own only a fraction of a percent of their firms' stock, and the largest investors are often pension funds with stakes below five percent. They are free-standing in that they own stock in no other domestically listed firm, and no other domestically listed firm owns stock in them.

III. Possible Advantages of Family Control

Economists like to assume that if an economic structure is commonplace, it must have survival traits – features that give it an edge over alternative structures. If family controlled pyramids are commonplace, perhaps they have some advantage over free-standing widely held firms.

Freedom from Agency Problems?

One common theme in discussions of family firms is that they are allegedly free of *agency problems*. Agency problems occur when the professional managers in a widely held firm maximize their personal utility, rather than the wealth of the firm's investors. For example, a professional manager might spend a million dollars on an unnecessary executive jet that gives her utility, even though this decreases the value of the firm. Jensen and Meckling (1976) use the term agency problem because, when such things occur, the professional managers are failing in their fiduciary duty to be faithful agents of the shareholders. We use the term *other peoples money agency problem* to distinguish this from other ways in which this fiduciary duty can be compromised.

Controlling shareholders, when they do exist, in the United States and United Kingdom are often seen as able to limit agency problems of this sort. Large shareholders, with considerable wealth tied up in the company, are unlikely to allow professional managers too much leeway to neglect the firm. Vishny and Shleifer (1986) develop this logic in an economic model. Anderson and Reeb (2003) and others find evidence consistent with large shareholders in the United States improving firm performance. Could control pyramids, by spreading a dominant shareholder across many firms, improve corporate governance on a larger scale and therefore provide an economic advantage to their member firms because they eliminate other people's money agency problems?

We think this explanation to be unlikely in general. The reason a large shareholder is thought to improve corporate governance in the United States and United Kingdom is that she has a large fortunes tied up in the firm and is keen to disallow mismanagement. But the previous section shows that control pyramids allow the family owning the apex firm to control numerous other firms with very little of their own wealth in each. If the family running the apex firm in the pyramid in Figure 2 ordered that Firm F spend a million dollars on an executive jet for the family's use, the value of Firm F would presumably fall by one million dollars. But we have already seen that this translates to a decline of $17,596 in the apex firm. The family might be loath to spend a million dollars on an executive jet, but $17,596 is a price even a university professor might find attractive. In short, the attenuated actual financial stakes the controlling family has in firms in the lower tiers of pyramids (which includes most of the firms in any given pyramid) basically recreates the same incentive problems that can occur in widely held firms. Insiders, this time the family, rather than the professional managers, spend outside shareholders' money on things they want, rather than things that build firm value.

Moreover, there are plausible reasons for thinking that governance problems in pyramid firms might be worse than in widely held firms. This is because widely held firms that are too severely mismanaged suffer stock price declines. These, in turn, trigger shareholder lawsuits, hostile takeovers, challenges by institutional investors at shareholder meetings, and other pressures that often lead to management's ouster and to corporate policy more aligned with value maximization. Shareholder lawsuits are virtually unknown outside the United States, hostile takeovers are not possible if the pyramid is held together with control stakes greater than fifty percent, and institutional investors cannot force their representatives onto boards in shareholder meetings where more than fifty percent of the votes are controlled by the wealthy family. When managers cannot be ousted, Morck *et al.* (1988), Stulz (1988), and others say that the firm has an *entrenchment agency problem*. In the United States and United Kingdom, widely held firms are prone to other people's money agency problems while firms with dominant insider shareholders are prone to entrenchment agency problems. In contrast, the firms in pyramids are vulnerable to both at the same time.

Furthermore, pyramid member firms are vulnerable to a third sort of agency problem that is not generally thought of in countries of free-standing firms. This is the intercorporate transfer of wealth among pyramid firms to advantage the controlling shareholder – what Johnson *et al.* (2000) call *tunneling*. To see this, suppose an asset of Firm F in Figure 2 rises in value by a million dollars. As already noted, only $17,596 of this gain ultimately accrues to the family firm at the pyramid's apex. The rest is diverted to one level after another of public shareholders. However, the family controls Firm F's board since it controls that of Firm E, which it controls because it controls the board of Firm D, and so on. The Family might order Firm F to sell the asset to a firm in a higher tier of the pyramid at cost. For example, if Firm F sells the asset to Firm A at its old, low price, the additional million dollars shows up in Firm A instead, and now the family's wealth rises by $500,000 instead of only $17,596. Tunneling, an agency problem where the controlling shareholder moves wealth out of firms whose cash flows mainly go to public shareholders and into firms whose cash flows accrue mainly to the controlling shareholder.

Consistent with all the above points, Morck *et al.* (2000) find that Canadian heir controlled firms, many of which belong to pyramids, underperform United States industry peer firms of comparable size and age, while widely held Canadian firms do not. Claessens, Djankov, Fan, and Lang (2002) investigate the role of pyramids more directly, and find that firm value falls when the control rights of the largest shareholder exceed its cash-flow ownership in a study of Asian firms. Lins (2003) reproduces this finding in a study of control pyramids in emerging economies, and also finds that the effect is weaker in countries with better legal protection for public shareholders and in pyramid firms with large outside shareholders. Presumably, both the law and large independent shareholders prevent tunneling and induce better governance.

Bertrand, Mehta, and Mullainathan (2002) test for tunneling among Indian pyramid group firms by looking for effects of shocks to one pyramid firm in the stock prices of others. They conclude that tunneling is economically important in Indian control pyramids. Bae, Kang, and Kim (2002) report concordant evidence for Korean family run control pyramids, or *chaebol*. Lemmon and Lins (2003) report that firms low in control pyramids suffered disproportionately in the Asian Crisis of the 1990s, which is consistent with the tunneling of wealth from those firms to firms nearer the apexes. Attig, Fischer and Gadhoum (2003) report evidence consitent with tunneling in Canadian control pyramids.

Faccio and Lang (2002), in contrast, conclude that tunneling is not widespread in Western European control pyramids, and suggest that this might be because the better legal environments constraint contgrolling owners more tightly in Europe than in Asia or emerging economies.

Thus, the contention that family control pyramids attenuate agency problems seems unlikely for three reasons. First, the lower tier firms in control pyramids, which contain most of the real assets, are subject to much the same other people's money agency problems as are widely held firms. Second, the controlling family is entrenched, as it cannot be ousted by disgruntled shareholders. Consequently, pyramid firms can suffer from entrenchment agency problems. Third, pyramids create scope for a new sort of agency problem – tunneling. Empirical work to date is broadly consistent with this viewpoint.

Long-term Planning?

Another set of arguments for the superiority of family control has to do with families having longer time horizons than public shareholders or professional managers. Allegedly, widely held firms must pander to myopic shareholders fixation on short term earnings, and this adversely affects longer term corporate performance.

That public shareholders are myopic, and focus only on short term earnings, has long been debunked. The share prices of United States firms that announce increases in long term investment rise abruptly, indicating that shareholders like long-term investments and rush to buy the stocks of firms that do more.[3] Thus, the view that widely held firms are constrained by shareholders to adopt short term planning horizons seems implausible. A more likely scenario might be that professional managers have planning horizons concurrent with their expected careers.

However, this suggests that countries in which control pyramids dominate should have higher long-term investment than countries where most large firms are professionally managed. In fact, Morck *et al.* (2000) report that Canadian heir controlled firms underinvest in R&D relative to their industry peer firms of similar age and size. They also report that countries in which old family billionaire wealth is larger relative to GDP have lower private sector R&D spending.

Finally, Landes (1949) reports that French mercantile families, excessively concerned about preserving their firms for their heirs, avoided risks and curtailed expansion. He argues that this adversely affected the historical development of the French economy. In contrast, Anderson and Reeb (2003) find no evidence of such an effect in the United States, and Daniels *et al.* (1994) report that firms belonging to one of the Canadian Bronfman family's pyramids were more highly leveraged than other comparable firms.

Whether family control provides a long-term planning advantage or the opposite, and if so, under what circumstances, remain open questions. Current evidence fails to support the contention, however.

[3] McConnell and Muscarella (1985) show that US firms share prices rise when they increase spending on fixed assets, a form of long term investment. Chan *et al.* (1990) report similar results for increases in R&D spending, perhaps the investment with the longest time horizon. Hall (1993) documents a highly significant positive correlation between shareholder value and R&D spending.

Family Values?

Another possible virtue of family control is that families, because of the blood ties that unite them, are better able to manage corporate affairs smoothly. However the actual governance of family firms is replete with intrafamilial disagreements, especially disputes about succession, the exploitation of some family members by others, and so on. While the view that "family values" somehow instill higher standards of performance is plausible to many – especially members of controlling families, consistent evidence supporting this view has yet to emerge.

Anderson and Reeb (2003) report that family firms, broadly defined as including any firms with dominant shareholders, outperform widely held firms in the United States. One possibility is that the very strong investor protection laws of the United States allow these benefits to shine through, while weaker protection elsewhere allows the three types of agency problems listed above to dominate, accounting for the empirical results discussed above.

However, family control seems associated with superior performance in some low income countries as well. Khanna and Palepu (2000) report that Indian pyramid member firms outperform free standing firms. Khanna and Rivkin (2001) argue that family control can bestow other advantages in economies with deeply dysfunctional institutions. If education is poor, family apprenticeships may be the best business training. If capital, labor, and product markets are corrupt and expensive to work with, pyramid group firms providing capital to each other, training workers for each other, and selling goods and services to each other may be an "optimal second best solution".

The same authors also suggest that a family with a good reputation can greatly expand the scope and scale of its business dealings with control pyramids. In an economy where corruption is rife, such a family is a preferred business partner, and the firms it controls are at an advantage.

These arguments may well be accurate. However, they point to the family firm as a "fix" for deep problems in an economy, such as poor education, corruption, and so on. This hardly seems a resounding endorsement of family control *per se*.

Moreover, what is good for family groups may remain bad for an economy. Almeida and Wolfenzon (2003) advance the insight that physical capital is possibly over-used within multi-project organizations in the sense that more productive applications outside of the organization are forgone. Their argument suggests that even if physical capital is efficiently allocated within a group, economy wide allocation may still be inefficient in the sense that a group would have less incentive to relinquish productive assets to outside users than is socially optimal. The Almeida and Wolfenson argument suggests that the presence of an internal capital market in an environment with inefficient external capital market may not even be the second best alternative from a social perspective. Indeed, according to them, the more capital is efficiently allocated within a conglomerate, the more it may lead to more misallocation of capital in the economy.

Political Connections

Morck *et al.* (2000), Morck and Yeung (2003), and others speculate that the families that run control pyramids may have unique political influence in many countries, and that this might account for their survival, regardless of whether they outperform or underperform other firms. Morck and Yeung (2003) argue that family pyramids are preferable trading partners for corrupt politicians. Family firms are more likely to return past favors because of a longer continuity of management. Control pyramids allow a higher level of discretion, for favors done for one firm can be returned by another. Since only a few families typically run the control pyramids that include most important firms in most countries, politicians need maintain relationships with only a few patriarchs. In addition, family controlling pyramids are more able to come up with side payments for politicians because they are able to pay using "other people's money" at lower tier pyramidal firms. At the same time, they are able to collect benefits for the family from political favors paid to any levels of their pyramids of firm via "tunneling."

For these and other reasons, they propose that a high prevalence of family firms, especially when grouped into a few great control pyramids, is a symptom of extensive "business-government cooperation". This can, and probably does, reflect corruption in most cases. But it could also reflect joint efforts at "nation building". The latter interpretation is especially favored by some as an explanation for the prevalence of control pyramids in Malaysia, Singapore, and Sweden.

V. Explaining the Importance of Families in Developing Market Economies

All of the above points conspire to promote family control pyramids in emerging economies because these countries have weak institutions – including education systems, courts, financial regulators, and organs of government.

Poor education systems leave potentially brilliant managers to lives as illiterate peasants, and may well make the members of a few dominant families, able to afford to send their sons to elite educational institutions abroad, the most able managers. Thus, there is a constricted supply of competent managers.

But there is also probably a constricted demand for professional managers as well. Educated peasants are apt to be viewed with suspicion by the established elite families, and feared as disloyal. Controlling owners and public shareholders rationally expect professional managers to behave opportunistically. Professional managers may be deeply unreliable if the courts and regulators fail utterly to restrain their pursuit of their own self interest, rendering diffuse ownership less desirable even than control pyramids. With no legal penalties, professional managers may opt to simply loot the firm, with no concern for its future or for the wealth of its shareholders.

Corrupt or inefficient courts doubtless magnify the importance of a reputation for fair dealing. A connection with such a family, however distorted by layers of pyramidal control, may be a great asset to a firm operating in a country where legal remedies for fraud are absent. In emerging economies, precisely because property rights are least well defined, firm value often depends on connections. Family connections are "institutional" features to supplement or, more explicitly, replace the dysfunctional institutions that induce such opportunism. A family tie is tangible, and family loyalty is often strong where arm's length institutions are weak. Family loyalty also includes a duty to preserve a patrimony for one's descendents, and thus instills longer planning horizons. Sharing a connection with the same controlling family allows trust between businesses in an economy where trust is scarce. Economic patterns follow kinship relations because they are the only reliable guarantors of trustworthy behavior in the absence of reliable courts, regulators, and so on.

Transforming a control pyramid into many free standing widely held firms in these countries trades away the benefits of family control discussed above - such as a family "name" and reputation, as well as private benefits due to tunneling, political connections, and the like. If public shareholders rights are ill protected, they should rationally foresee looting of the firm by professional managers. Consequently, they are unlikely to pay a high enough price for the controlling owner's shares to fully compensate her for these losses. Indeed, poor legal protection most likely means very low prices for these shares.

The framework has several implications. A well developed legal and regulatory system that makes public investors confident of their property rights encourages families to sell out. Heirs may come to realize that professionals can run the family's firms better, and may opt to become passive investors with diversified portfolios of stock in firms they do not control. This appears to be the path chosen by numerous wealthy American heirs, including the Rockefellers.

In a regime with partially developed institutions, the entrepreneur may hire professional managers, but retain control to monitor them closely. Where market mechanisms, like takeovers, independent audits, full disclosure, and institutional investors, fail to discipline errant managers, an intermediate degree of professionalization happens. This is observed in economies with enough investment in education, but with ill regulated capital markets, such as many East Asian companies.

In a country where institutions are thoroughly dysfunctional, the founding family must run its firms directly. When courts, regulators, and the state are entirely corrupt, bestowing governance power on an outsider is an invitation to theft. Professional managers are acceptable only if they join the family through marriages, as was common in Pre-War Japan.[4]

This absence of trust in professional managers and intense reliance on kinship is self-reinforcing in a way that may further impede development. If professional managers are expected to steal, they may not be rewarded for honesty. This may induce them to steal. The situation is akin to that of police who are corrupt because they are underpaid and underpaid because they are corrupt. The overall effect is to lock in family control, shut outsiders out of careers in business management, and reduce outsiders' incentives to become educated. The absence of widely held, professionally managed firms retards the development of capital markets and institutions, which feeds back to reinforce the need for family control in the first place. The end result is that family control amid general poverty is a stable equilibrium.

[4] The argument is first made in Burkart, Panunzi and Shleifer (2003).

IV. Determinants of Pervasive Family Control in Emerging and Developed Economies

Different countries have very different patterns of ownership of their large corporations. Why this came to be is the subject of ongoing research by the authors of this study and others. However, preliminary findings point to several key issues:

1. La Porta *et al.* (1999) show that a country's legal and regulatory standards are related to the ownership structures of its large corporations. Countries with endemic corruption, with poor shareholder legal protection, corrupt judiciaries, and the like tend to have highly concentrated ownership, and this usually involves wealthy families with control pyramids.

    The reasons for this pattern are not fully clear at present. One candidate explanation, proposed by Shleifer and Wolfenzon (2003) is that large shareholders cannot sell out in such environments because becoming a diversified passive investor in other firms is simply not a viable alternative. Another, proposed by Morck and Yeung (2003), is that control pyramids greatly magnify the returns to making deals with corrupt politicians in such countries, and are consequently a preferred form of organization.

    One possible implication of these arguments is that reducing the level of corruption in a country might also reduce the extent of wealthy family control over its economy. However, caution is warranted. While there are no instances of deeply corrupt countries with a prevalence of widely held firms, there are many passably honest countries in which family firms are important. Sweden and Canada are but two examples. Thus, honest institutions might be a prerequisite for dispersed ownership, but not a cause of it.

2. A country's tax system probably has implications for the allocation of control over its great corporations. Morck (2003) shows that, with certain qualifications and exceptions, dividends paid by one firm to another are subject to double taxation in the United States, but virtually everywhere else dividends are only taxable when paid by a company to an individual. This makes control pyramids, such as the structure in Figure 1, deeply tax disadvantaged. In the United States, taxes are leveled on the dividend firm F pays to Firm E. When Firm E passes this money along to Firm D as a dividend, taxes fall due again. Thus, the dividends Firm F pays are taxed many times before accruing to the family firm at pyramid's apex. Morck (2003) shows that the United States adopted this system of taxation in the 1930s explicitly to force the breakup of control

pyramids. Becht and DeLong (2003) show that control pyramids were ubiquitous in the United States until the 1930s, and then abruptly disappeared. Another cause of this was certainly the Public Utilities Holding Companies Act which banned pyramiding outright among public utilities firms.

Morck *et al.* (2003) show that about half of Canada's great corporations belong to family pyramids now, and that the situation was almost precisely the same a century ago. But in the 1960s, most Canadian firms were widely held. They raise several possible explanations, but one is that Canada levied a high inheritance tax until the 1970s, when it was replaced by a capital gains tax with extensive loopholes. The United States, in contrast, continued to enforce an inheritance tax at much higher levels than apply in most European countries.

This suggests that a country might break up its control pyramids by adopting a United States style tax code that subjects inter-corporate dividends to double (i.e. multiple) taxation, or that taxes inheritances heavily. However, caution is warranted because Aganin and Volpin (2003) show that Italy's adoption of such a tax code did not discourage pyramiding. One possible explanation is that the Italian code was not vigorously enforced, or contained loopholes.

3. Roe (2003) points out that rich countries with extensive family control pyramids tend to be more social democratic, while those with dispersed ownership tend to have more liberal politics. He proposes that strong owners are needed to balance the power accorded organized labor in social democracies, and that this is why family run control pyramids persist in those economies.

This is an interesting insight, but its empirical pedigree is clouded by the extreme leftist politics of the United Kingdom in the 1970s apparently coexisting with dispersed ownership, and the importance of banks, rather than families, in the governance of German firms. It may be possible to explain these discrepancies, but other explanations for Roe's observation are possible. For example, Högfeldt (2003) argues that a symbiotic relationship between Sweden's social democratic rulers and her great mercantile families developed over time. The Social Democrats taxed income heavily, preventing the emergence of new competitors and locking in the supremacy of established firms. In return, Sweden's great families supported the SDP.

4. It may be that openness to the world economy curtails the benefits of control pyramids. Morck *et al.* (2000) show that Canada's acceptance of free trade with the United States in 1988 triggered a fall in the share prices of firms controlled by its old billionaire families relative to the share prices of independent firms. They propose that free trade was expected to raise competitive pressures and make political connections less valuable; and that these effects benefited independent firms, which were more competitive, and harmed old family firms, which were better connected to the country's political elite.

   This suggests that globalization, by increasing competitive pressures and reducing the value of political connections, might undermine the advantages that sustained control pyramids in many countries[5]. This explanation is, of course, dependent on the premise that control pyramids exist primarily to attract, capture, and funnel political intervention in the economy.

VII. Implications

A more basic issue remains open, though: Ought government policy to support control pyramids or break them up? Morck *et al.* (2000) argue that entrusting extensive corporate control to a few old families is generally undesirable. They find that countries with old billionaire wealth larger relative to GDP grow more slowly than otherwise similar countries with few billionaires or with new money billionaires. They view control pyramids as locking in the economic dominance of established old money families.

Morck *et al.* (2000) also report that Canadian firms controlled by old money families do less R&D, and that the corporate sectors of countries in which inherited billionaire wealth is more important spend less on R&D. Since much evidence now supports Schumpeter's (1934) thesis that innovation is the primary engine of economic growth, this is of concern. Much innovation is disruptive of old established firms. The advent of the personal computer was a difficult time for makers of mainframe computers, and many failed. They suggest that established wealthy families might suppress innovation to preserve the value of their existing capital assets.

They also report that old money Canadian firms appear to have enjoyed preferential access to capital, at least prior to free-trade with the United States. If old money families can exercise control over their countries banking systems, either directly by controlling the banks or indirectly by lobbying politicians and bureaucrats, this also bodes ill. King and Levine (1993) argue that the key role of a country's financial system is to back innovators, thereby promoting growth. A financial system too much controlled by old money might be loath to do this for the reasons cited above.

Nonetheless, adopting policies aimed only at undermining family control pyramids may not be advisable. Shleifer and Wolfenzon (2002) warn us that an absence of corruption and well-developed shareholder rights probably make dispersed ownership unviable. Khanna and Rivkin (2001) warn us that family control pyramids may be a sensible adaptation to dysfunctional markets and institutions in many developing countries. The United States, as it adopted tax and other policies to undermine pyramids, also greatly strengthened the legal protection accorded public shareholders by establishing the SEC and funding it well. This happy confluence allowed dispersed ownership to continue. In contrast, Morck and Nakamura (2003) show that the dispersed ownership introduced in Japan by the United States Occupation Force without similar accompanying reforms in the late 1940s did not survive.

Finally, the conclusions of Morck *et al.* (2000) that family control pyramids are consistent with a North American perspective on democracy with checks and balances, in which any great concentration of power is undesirable. Europeans, Asians, Latin Americans, and Africans, with more recent traditions of feudalism and socialism may find a concentration of economic power in benevolent hands reassuring.

[5] See also, Rajan and Zingales (2003).

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Figure 1. The Importance of New Money and Old Family Billionaire Wealth in the Economies of Different parts of the World

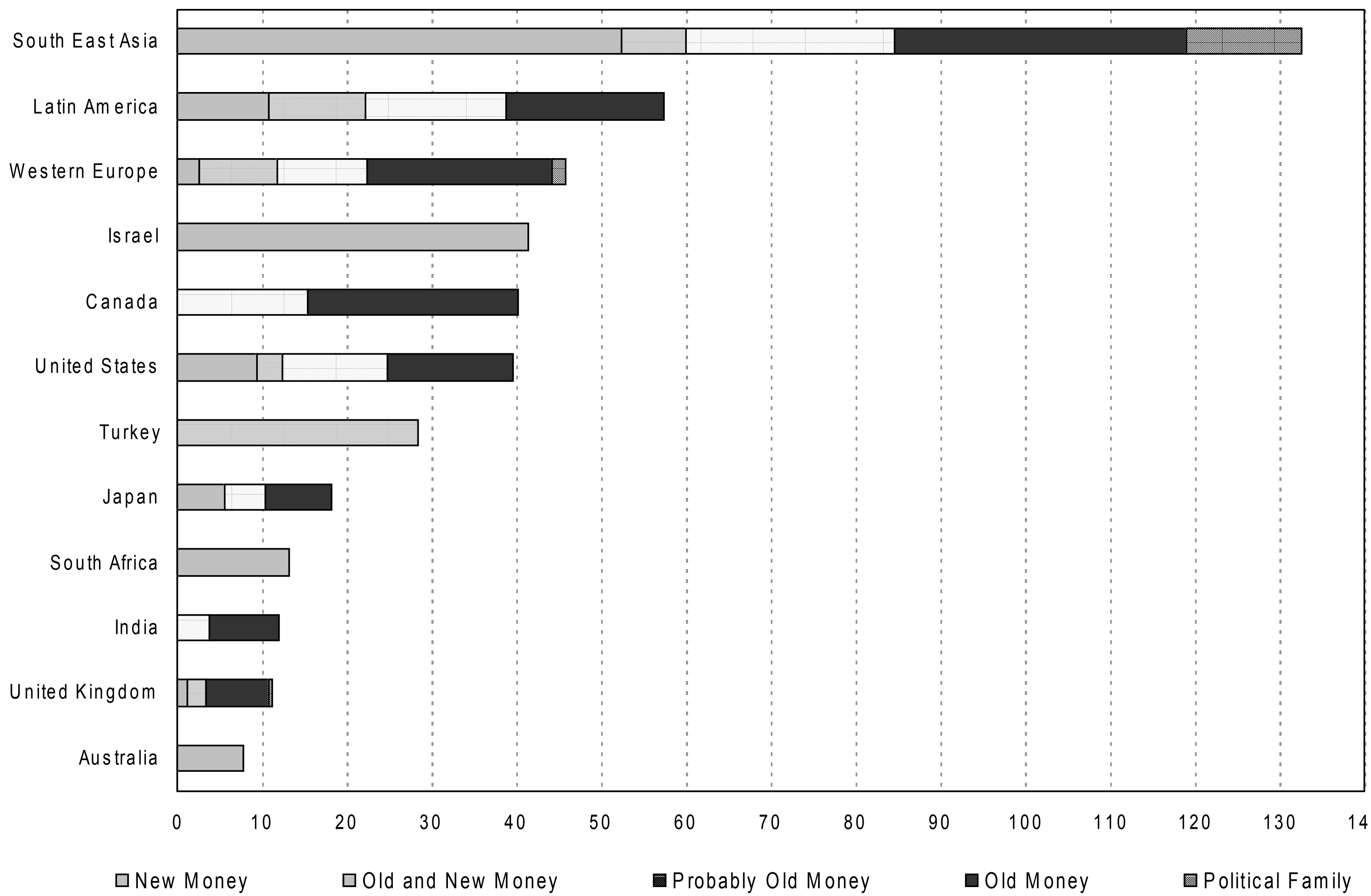

Figure 2
A Stylized Diagram of a Typical Corporate Control Pyramid