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Business groups and the natural state☆

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ABSTRACT

Recent revisionist accounts of corporate governance in both business history and finance are challenging the tradition narrative, associated with Berle and Means (1932) and Chandler (1977), in which the American model of diffuse ownership and coherent diversification is both an inevitable outcome of economic development and perhaps a normative standard for the world to follow. This essay is an attempt to rethink that narrative in light of the continued significance of the pyramidal business group as a governance structure around the world. I argue that business groups arise in response both to inadequacies in arm's-length markets and to the needs of what North et al. (2009) call the "natural state." In this view, the quality of markets and the demands of the state are tightly interconnected phenomena. Such a perspective explains the emergence of business groups in developing countries as well as their persistence even in wealthy and sophisticated polities apart from the U.S. and the U.K. In the end, moreover, I endorse the view that the much-discussed and oft-misunderstood exceptionalism of the U.S. in corporate governance arises not only from the sophistication of American markets but also importantly from government policies toward corporate taxation and securities regulation—policies that arose from the unique Public Choice problem posed by the differential effect on the U.S. of the collapse of globalization during the middle years of the twentieth century.

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1. Introduction

Not too many years ago, our understanding of the evolution of corporate structure in the modern era fit within a dominant theoretical narrative. We learned early on from Berle and Means (1932) that, by the early twentieth century, the owner-managed firm had given way in the United States to a corporate form in which ownership was diffuse and inactive and in which control had effectively passed to managers. Then we learned from Chandler (1977) that this managerial revolution was both inevitable and desirable.[1] The separation of ownership from control allowed managers to reorganize production along efficient bureaucratic lines, creating the modern multi-unit (vertically integrated) firm (Chandler, 1977) and eventually the multidivisional corporation (Chandler, 1962). The progression away from owner control and toward diffuse stock holdings and professional management took place first and proceeded most quickly in the United States, whereas the vestiges of what Chandler came to call "personal" capitalism persisted in Europe, especially Britain, preventing firms in those countries

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[1] Indeed, Lamoreaux et al. (2004) go so far as to accuse Chandler of Whig history. For a fuller discussion of the issues, see Langlois (2004).

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from taking full advantage of economies of scale and scope, and dooming Europe (apart from Germany) to relative industrial decline (Chandler, 1990).

Although this account was certainly not without its critics, it long enjoyed the status of a comfortable conventional wisdom. The situation today is arguably rather different. The conventional wisdom still remains entrenched in scholarship generally; but among specialists in business history and corporate finance, a multi-faceted revisionism is in flower. Depending on how one looks at the data, it is no longer so clear that the separation of ownership from control was (or is) quite so rampant in the United States as the Berle and Means account would lead us to believe (Desai et al., 2005; Holderness, 2009; Holderness et al., 1999). It is also not so obvious anymore that the separation of ownership from control was more advanced, or that personal capitalism was less characteristic, in the U.S. than in Britain in the early twentieth century (Hannah, 2007a,b). In place of the linear, and perhaps even triumphalist, narrative of Chandler there is now emerging a more contingent story in which forms of corporate governance vary considerably across both time and geography. Even in the United States, the vertically integrated managerial enterprise is arguably no longer the centerpiece of corporate organization (Lamoreaux et al., 2003; Langlois, 2003). And, outside the U.S. and the U.K., the dominant form of governance is not the Chandlerian firm but the pyramidal business group, a form under which, far from ceding authority entirely to professional managers, owners retain effective control over large empires (La Porta et al., 1999).

These new perspectives on corporate governance in the early twenty-first century call for a reexamination, and indeed a rewriting, of the Berle–Means–Chandler narrative. In earlier work (Langlois, 2003, 2007a) I have tried to rethink the issue of the late-twentieth-century vertical disintegration of the Chandlerian firm in what was essentially an American context. This essay is a preliminary attempt to widen the analysis to consider corporate governance more generally and to look beyond the (real or imagined) American model of governance to alternatives that include the business group.

The term "business group" takes on a number of meanings in the literature, sometimes encompassing holding companies or loosely affiliated business networks (like Japanese *keiretsu* are supposed to be or have been). Scholars generally distinguish business groups from more loosely arranged structures like business networks. "When ownership and control are more centralized and organizational subunits enjoy limited autonomy, the commonly used term is business groups. When subunits enjoy more autonomy with respect to ownership, control, and operations, interfirm network is the correct term. In other words, business groups are more centralized and closely held, while interfirm networks are more decentralized and loosely held"[2] (Fruin, 2008). Following Colpan and Hikino (2010), I will consider the business group to have three defining features: (1) pyramidal ownership structure; (2) unrelated diversification; and (3) family (or sometimes government) control.

An archetypical "American-style" public corporation is owned by a large number of holders of common stock ("widows and orphans," in the jargon of finance). The American corporation may have divisions, even relatively autonomous ones. But those divisions are never themselves also public corporations; the divisions are never listed on exchanges. Moreover, especially by world standards, the divisions of American corporations tend to be closely related to one another in the products they deal with and in the capabilities the draw on (Teece et al., 1994). All of this stands in contrast to the pyramidal form that dominates outside the Anglo-American world. At the apex of the pyramid typically stands a tightly held entity, generally under the control of a family. That entity owns a controlling interest in a set of publicly traded firms, which firms in turn hold controlling interest in a lower layer of publicly traded firms. And so on down. Taken as a portfolio, the pyramid reflects far less coherence in its diversification than does the typical American firm. The ultimate result of the pyramidal structure is that the entity standing at the apex leverages control over what is often a vast empire, all the while actually holding only a fraction of the total equity the group represents.

Why these differences? The raw material for my answer will come from the New Institutional Economics in its broadest sense (Klein, 2000; Langlois, 1986). Although one can take advantage of this approach to compare specific kinds of arrangements, including those of corporate governance, the signal thought experiment in the literature is to compare "the market" as an organizational structure with "the firm" as an organizational structure (Coase, 1937). To an extent not often appreciated, however, the imperfect "market" in the economics of organization is actually a relatively well-functioning structure as real-world markets go. The underlying assumption, normally unspoken, is that relevant background institutions—things like respect for private property, contract law, courts—are all in place. Whatever transaction costs then arise are thus the result of properties inherent in "the market" itself, not of inadequacies in background institutions.[3] There is generally a tacit factual or historical assumption as well: that the relevant markets exist thickly or would come into existence instantaneously if called upon.[4] In the economics of organization, then, firms arise because, under certain circumstance, they are inherently

[2] The personal computer industry in the twentieth century and the Lancashire textile industry in the nineteenth are interfirm networks only in the broadest sense, and fall more into the category of industrial districts as understood by Marshall (1920, IV.x.3). (The personal computer industry is not as localized as was the Lancashire textile industry, but Silicon Valley is clearly a hub, with nodes at places like Austin, Seattle, and Taipei.) Of course, there are industrial districts that have more the character of interfirm networks. The Naugatuck Valley brass industry in Western Connecticut was an industrial district in which there was significant overlapping ownership of enterprises, and this identifiable group of owners was also responsible for bringing into existence various market-supporting institutions and complementary resources such as banks and a rail link to New Haven (Everett, 1997).

[3] As I will argue in due course, the imperfections that the economics of organization tends to discover in "markets" are not in fact inherent but are the result of the historical state of the market (market thickness or extent) or of institutions, especially those intermediate-level institutions I will describe as market-supporting institutions.

[4] Williamson (1975, p. 20) is fond of assuming that "in the beginning there were markets." He means this as a heuristic dictum not a historical claim: let's assume that markets and firms are both equally capable – that both (and other forms, too, perhaps) exist and have at their disposal the same productive

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