

Perpetuating inequality

To those that have

The dark side of family capitalism

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FOR MOST PEOPLE the chance to fly business class, let alone first, is a rare pleasure. But Heather Cho was not enjoying herself. As the Korean Airlines flight taxied onto the runway at New York's John F. Kennedy International Airport last December, she was fuming over her macadamia nuts, which had been served in a paper bag rather than on a plate. She used her position as one of the airline's senior executives, not to mention the owner's daughter, to demand an apology, and ordered the plane to return to the terminal so the offending steward could be taken off the plane. The "nut rage" incident, and the message it conveyed about the gap between the rich and powerful and the rest, started an agonised debate in South Korea.



Even by Asian standards, South Korean capitalism is unusually family-focused. About 20 families run the huge conglomerates or *chaebol* that make up 60% of the country's stockmarket value and most of its exports. The leading one alone, Samsung, accounts for 25% of South Korea's exports, putting enormous power in the hands of its ruling family, the Lees. Most South Koreans revere the *chaebol*. They powered the "miracle on the Han river" which transformed a war-torn backwater into a comfortable middle-income country. That reverence extends to the great patriarchs who turned the *chaebol* into mighty industrial machines. But doubts are creeping in.

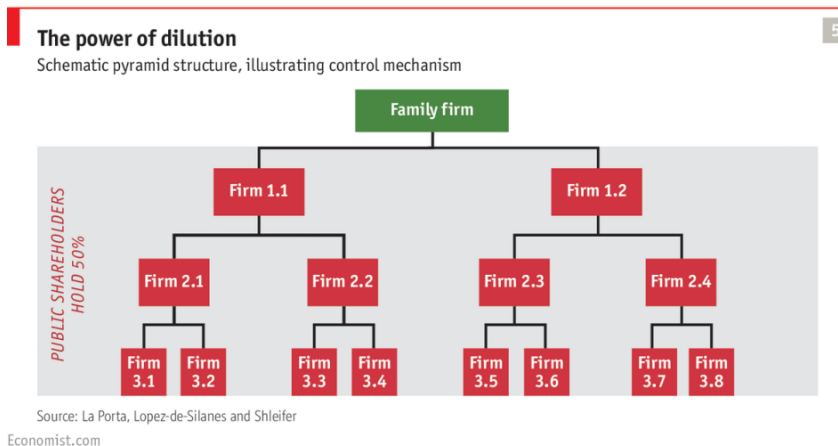
South Korea puts great emphasis on upward mobility and social solidarity, yet the country is increasingly ruled by a collection of old families whose members marry each other and inherit all the best jobs. The concentration of wealth produces a range of other problems. Political cronyism is rife. Corporate governance is shoddy, with *chaebol* families exercising power through convoluted ownership structures.

The chairmen of Samsung, Hyundai Motor, SK and Hanwha have all been convicted of crimes, and three of them have spent time behind bars.

Worse than you think

South Korea's concern about inequality taps into a worldwide debate about the increasingly unequal distribution of wealth, to which Thomas Piketty's book, "Capital in the Twenty-First Century", published in 2013, made a notable contribution. Mr Piketty, a French economist, does not devote much space to family companies: his argument is that inequality is growing rapidly because the returns on capital are higher than the rate of economic growth. But the extent to which families are able to perpetuate and leverage their wealth suggests that the problem may be even worse than Mr Piketty thinks.

Bill Gates, the world's richest man, has countered Mr Piketty's thesis by arguing that wealth dissolves over time: families either lose their money through incompetence or give it away to charities. But families are getting better at breaking the clogs-to-clogs cycle. They are not only learning how to manage family companies and family fortunes better; scions of family fortunes are also increasingly marrying intelligent partners who can help them run their companies. A growing number of them are determined to work for their living. The industrious rich could prove far more of a threat to equality of opportunity than the idle rich.

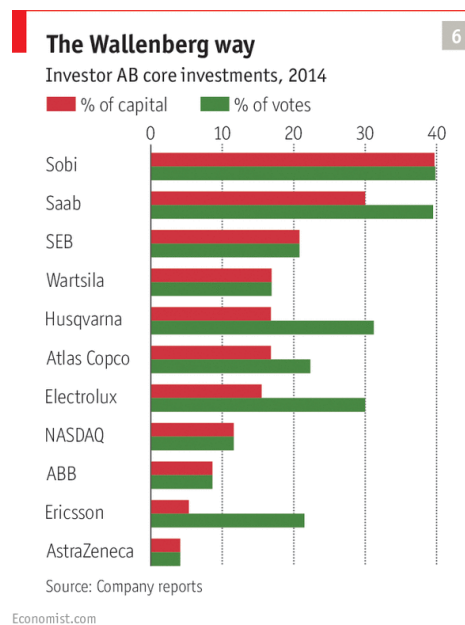


The desire to preserve wealth lies behind one of the biggest problems with family companies, poor corporate governance and lack of transparency. Families set up convoluted structures to prevent outsiders from gaining control. The most extreme example of this is South Korea, but in Europe, too, many families use foundations or investment vehicles to keep control.

Business families have developed ways of exercising corporate power, such as control pyramids and dual-class shareholdings, that go far beyond their formal ownership. Randall Morck, the academic, finds that in large parts of the world pyramidal business groups allow "mere handfuls of wealthy families" to control entire economies (see chart 5, for a schematic view of how this works). This problem is particularly marked in developing countries, but is also common in much of the rich world, except in the Anglo-Saxon sphere. In Sweden, which is widely regarded as one of the world's most egalitarian countries, one family, the Wallenbergs, controls a big chunk of the Stockholm Stock Exchange, thanks to

a family-run investment fund and a complicated system of privileged shares and pyramid holdings (see chart 6). Mr Morck also calculates that the top ten families control 34% of Portugal's market capitalisation and 29% of France's and Switzerland's.

Pyramids may have had an economic justification during the early stages of capitalism, but that has largely gone as institutional voids have been filled. America launched a vigorous war on pyramid structures during the New Deal, and by 1937 American companies were as widely held as they are today. Britain fought an anti-pyramid campaign in the late 1960s, with equally rapid results. Now Israel is stopping the oligarchs who control most of its domestic economy from using pyramid holdings, on the grounds that they reduce competition and raise domestic prices. Countries such as India and Brazil would do well to study Israel's example—and even Sweden might have a rethink.



Business families have also proved adept at consolidating their positions through political marriages. Paul Desmarais junior, one of Canada's richest people, whose family trust owns Power Corporation, among other companies, is related by marriage to Jean Chrétien, a former prime minister. Jessica Sebaoun-Darty, an heiress of a vending-machine empire, is married to Jean Sarkozy, a son of a former French president. The Lees, who own Samsung, are connected by marriage to four other *chaebol* (LG, Hyundai, Kolon and Pooan) and many leading politicians, including a former South Korean prime minister. The Toyoda family network includes two former prime ministers and seven big Japanese business empires.

Other successful techniques include going into politics yourself (like the Rockefellers or the Kennedys), funding political campaigns and cultivating friendships with politicians. Such political connections are pervasive in Latin America where, thanks to weak property rights and a long history of political interference, even the most virtuous companies have to keep in with politicians. In Colombia, two of the richest families, Sarmiento (banking) and Santo Domingo (beer) own the two main newspapers. Carlos Slim was said to be the main funder of Andrés Manuel López Obrador, the populist leader of the

Mexican left. JBS, a giant Brazilian meat company that has expanded with the help of funds from the national development bank, BNDES, was the biggest donor in the Brazilian election last year.

The problem of poor corporate governance is particularly severe in the Gulf region, where some \$1 trillion of family-business assets are due to be handed over to the next generation within five to ten years. Families can involve several wives and many children. The boundary between the firm and the family is often ill-defined and the courts, particularly in Saudi Arabia, are not well equipped to deal with complicated inheritance disputes.

The region is making an effort to improve the governance of family companies. Badr Jafar, the managing director of the Crescent Group, has set up the Pearl Initiative, which pushes for good practices such as the establishment of family councils. SABIS, a Lebanese education company, has established clear rules for succession planning and hiring new family members. The Zamil Group, a Saudi conglomerate, has set up an internal leadership programme open to both family and non-family. The Abdullatif Alissa Group, another Saudi conglomerate, has removed all family members from management positions, limiting their role to sitting on the board. But for every example of good planning there are dozens of botched successions.