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Family Control Business and Capital Market Development in ASEAN

Bany Ariffin Amin Noordin and Siong Hook Law***

This study examines the effect of family ownership structure on capital market development in four Association of Southeast Asian Nations (ASEAN) countries, namely, Thailand, Malaysia, Indonesia, and the Philippines using panel data analysis. The results indicate that greater family influence in the stock exchange has detrimental effect on capital market development. The results can be considered valid as three alternative capital market development indicators, namely stock market capitalization, total share value traded, and number of companies listed are used.

Introduction

According to La Porta *et al.* (1999), Claessens *et al.* (2000), and Wiwattanakit (2001), large corporation sectors in many economies crossing all levels of economic development are controlled by a small number of wealthy families. These families are able to control a vast amount of corporate assets—in many instances their family fortunes, and in some instances a considerable share of the host countries economies—through control pyramid,¹ cross-holding, and dual class share holding structures.

Claessens *et al.* (2000) findings show that the level of controls that the Asian family businesses have over the Asian economies, in general, is significant. For instance, in the East Asian countries, the family businesses control 50% of these economies, as measured in terms of total corporate assets. Family businesses, especially in Malaysia, control around 28% of the entire listed corporate assets. These observations suggest that relatively small number of wealthy owners of the business firms effectively control most of these economies.

As an alternative, total market capitalization held by the top five families was also used by Claessen *et al.* (2000) to measure the wealth concentration of the dominant families.

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¹ A typical family pyramid has an ultimate shareholder—a wealthy family or individual at its apex. This shareholder controls a number of listed firms by owning large blocks of voting equities. Each of these firms in turn controls more listed firms using similar mechanisms, and each of these next-tier firms in turn controls other firms. The control chain may go on many times and thus creates a corporate pyramid encompassing a huge number of listed firms. The shareholders at the apex is the ultimate shareholders of all the listed and non-listed firms in this pyramid, though their ownership commitment may diminish in firms going towards the bottom of the pyramid.

Based on this measure, Suharto and Ayalas² are ranked as the top family businesses in Indonesia and the Philippines respectively. Evidently, the share of controls of Suharto and Ayalas are more than half of the corporate sector, i.e., 57.7% and 52.5% respectively in terms of market capitalization. In Thailand and Malaysia also, the control is significant, as the largest five families dominate approximately a quarter of the corporate sector.³

Claessens *et al.* (2000) also point out that if the concentration of corporate control reigns in the hands of a few dominant family businesses, it might create powerful incentives and motives for them to lobby authority agencies and public officials for preferential treatments. The preferential treatments they seek may come in the form of privileged public contracts, non-market-based financing or other preferential means. These abilities consequently might lead to the suppression of minority rights and a delay in the overall financial development of the respective economies.

Therefore, this study tries to ascertain whether there is a relationship between the existence of these family businesses and the development of the capital market among the four Association of Southeast Asian Nations (ASEAN) members, namely, Thailand, Malaysia, Indonesia, and the Philippines. These four countries have been chosen specifically because of the significant presence of the family businesses control. As pointed out by Claessens *et al.* (2000) and Lemon and Lins (2003), in these countries, the family businesses control half of their countries economies. With such a significant amount of control, it might create a powerful inducement for the families to solicit special treatment from the government or to manipulate the capital market regulations to their advantage. If successful from such illusive acts, it then provides the families an absolute monopoly power in the capital market that grants them with an exclusive protection from competitions.

Schumpeter (1934) argues that innovation requires well-functioning financial markets for innovators who are generally not wealthy and require financial backing to start their business. In line with this argument, there are studies, which show that financial development is highly associated with economic growth (King and Levine, 1993; Rajan and Zingales, 1998; Henry, 2000; and Wurgler, 2000). On the other hand, when there is a presence of prominent family business, 'rent seeking'⁴ activities in the form of backing politicians and officials who would interfere with the efficient operations of the financial system would be highly likely

² Claessens *et al.* (2000) show that among the ASEAN countries, Indonesia has the largest number of companies controlled by a single family. The largest conglomerate in Indonesia, for example, is the Salim group which is mainly controlled by Soedono Salim, which is also in part controlled by the Suharto family. Collectively they controlled assets worth \$24 bn.

³ According to Suehiro (1993) the family business can be thought of as a form of enterprise in which both the ownership and management are controlled by a family kinship group either nuclear or extended, and the fruit of which remains inside that group, being distributed in some way among its members.

⁴ According to Morck *et al.* (2001) 'rent seeking' activity implies the extraction of uncompensated value from others without taking action which improve productivity or create mutually beneficial transaction. Krueger (1974) argues that the biggest barrier to economic growth is rent seeking activities or corruption. As illustrated by him, if investing a million dollars in Research and Development (R&D) yields a \$50,000 per year perpetual profit, it means the R&D has a 5% return. However, if investing the same million dollars in a bribe to a politician to change a law or provide a subsidy that increases profit by \$100,000 per year in perpetuity, this rent seeking activities investment has a 10% return. Real investment declines and bribery becomes prevalent. Lenway *et al.* (1996) and Mauro (1995) present empirical evidence supporting Krueger's (1974) hypothesis.

(Morck *et al.*, 2001). Consequent of this, it may prevent uprising of innovative new firms to threaten the already established family businesses.

Morck *et al.* (2001) and Johnson and Mitton (2003) describe how dominant families prefer dysfunctional financial systems because these serve as barriers to entry-limiting competition from new entrants, and locking in the dominant position of established family businesses. Additionally, Claessens *et al.* (2002), and Faccio and Lang (2002) provide evidence of public shareholders being abused by the controlling families of corporate groups in East Asian and European countries. These controlling families prefer a weak financial system because a stronger one would restrict such abusive behavior. Undermining the financial system, nevertheless, not only provides cover up for such illusive behavior but also indirectly retards growth, as that would prevent new businesses from obtaining financial backing on efficient terms.

There are several ways in which a family business can effectively impede the development of the capital market. One way is by restricting capital for entrepreneurs. It can be argued that in an efficient economy, the regulatory and institutional structures allocate capital to certain firms and limit the access to non-deserving firms. On the other hand, according to La Porta *et al.* (1999), in many countries such efficient allocation of funds process is distorted due to the influence of the prominent family business over the regulator. For example, government industrial policies in many countries direct capital toward large established family businesses. Plausibly, this is because these firms are more able to lobby for subsidies.

It was documented by Beason and Weinstein (1996) that after the World War II many of the Japanese established industries received significant amount of subsidy from the government despite being unprofitable. It was also documented that prior to the Asian financial crisis, the Korean government had an explicit policy of orchestrating generous low cost bank loans to large family-controlled *chaebol* corporate groups. Consequent of this financing policy, these family-controlled *chaebol* firms had a debt to equity ratio of 4.0 in 1996 but an average of unjustifiable 1% return equity in the same year. On the whole, due to the influence of the prominent business families over the regulator, established family firms have easy access to capital while the new entrants cannot raise money locally. This is consistent with the IMF's criticism that the financial market, especially in the developing countries, displaces new innovative businesses while preserving the monopolistic family businesses.

Another mechanism available for the family business to prevent the expansion of new business that might create rivalry is by preventing them from obtaining foreign capital. As indicated by Morck *et al.* (2001), firms in many countries have been prevented from obtaining foreign capital by restrictions on inwards investment flows. Explicit investment policies, by which being undermined by family business, may deter inward foreign portfolio investment are especially common in the emerging markets (Kim and Singal 1993). Such an argument is further supported by the empirical findings of Morck *et al.* (2001). They discover that in many of their sample countries, in which the family businesses are prominent, had a specific share classes in certain industry sectors that were unavailable to foreigners.

In addition, there is a ceiling on foreign shareholding or mandatory long holding period for foreign investors. Such regulations hinder foreign portfolio investment and inevitably may cause smaller firms.

Finally, the family business may also distort capital market development by limiting investment opportunity of the savers in the respective countries. Economic efficiency requires free competition for savers' money. Since the presence of family business corporation is significant, savers in many developing countries have little choice but to form an investment portfolio consisting of only the stocks of family-controlled companies. These limitations on savers' choice enables large family businesses to charge monopsony prices when accessing capital from the market. Once monopsony prices are infused, savers may not receive the appropriate price comparable to the risk they have to bare. Along the same argument, lack of choice for investment for savers in an economy may also hinders them from obtaining the needed diversifications advantage. In general, if such inadequacies in investment activities existed, it may cause investors to shun away from the capital market. As a result, suppression of liquidity in the market is inevitable.

In general, all of such distortions may cause impediments to the development of the capital market. When there are deficiencies in capital market development, a differential access to capital might arise between entrepreneurial firms and established family firms. Evidently, family businesses are expected to have more accessibility because of their dominance. As a result of this, family businesses might be able to expand more aggressively than would be a prudent entrepreneurial firm, thus, preventing entrepreneurial firms from rising to challenge the family businesses.

The findings of this study suggest that greater family influence in the specific country, the detrimental effect on capital market development is significant as well. The empirical results are valid based on three alternative capital market development indicators, namely, market capitalization, total share value traded, and the number of companies listed. The results also suggest that improvement in law and order situation is likely to deliver positive effect on capital market development in these economies.

Empirical Model

In this study, we employ the following log-linear equation to assess the effect of family business on capital market development:

$$\ln CD_{it} = \alpha_i + \beta_1 \ln RGDP_{it} + \beta_2 \ln OWN_{it} + \beta_3 \ln LO_{it} + \beta_4 PCIF_{it} + \varepsilon_{it} \quad \dots(1)$$

where CD is an indicator for capital market development, $RGDP$ is real GDP per capita, OWN is family influence, LO is law and order, and $PCIF$ is capital inflows.

The real GDP per capita acts as a control variable for the demand for financial services. If income rises, the demand for financial services is expected to rise, so β_1 is expected to be

positive. On the other hand, if family businesses control rise, the capital market development is expected to fall, therefore, β_2 is expected to be negative. According to Demetriades and Andrianova (2004), the success or failure of financial market development is determined by the quality of financial regulation and the rule of law. This view is developed further in Demetriades and Law (2006), who claim that financial market development has larger effects on economic growth when the financial market and system are embedded within a good institutional framework. Thus, the law and order is included in the model specification and β_3 is expected to be positive. The private capital flows are also included in the specification since greater capital flows will enhance the capital market development, so β_4 is expected to be positive.

In this study, we also hypothesize that greater law and order would reduce the impact of family businesses control on the development of capital market. In order to determine the role of law and order in minimizing the effect of family businesses influence on capital market, the interaction term between both variables is included in the model specification, which is as follows:

$$\ln CD_{it} = \alpha_i + \beta_1 \ln RGDP_{it} + \beta_2 \ln OWN_{it} + \beta_3 \ln LO_{it} + \beta_4 PCIF_{it} + \beta_5 (\ln OWN \times \ln LO)_{it} + \varepsilon_{it} \quad \dots(2)$$

If β_5 is positive and statistically significant, this implies that the interaction term between family ownership and law and order has a separate positive influence on capital market development, over and above the effect of the levels of family ownership and law and order.

Equations 1 and 2 provide the basis for the empirical models that are estimated in this study using the panel data analysis. The Breusch Pagan LM test is employed to test whether the dataset can be pooled, and the Hausman test is utilized to decide whether the fixed effect or random effect is more superior in the estimation.

The Data

In this study, the dataset consists of panel observation for four ASEAN countries, namely, Indonesia, Malaysia, Thailand, and the Philippines for the period 1986-2003. Singapore is excluded despite the fact that it has some large family-controlled businesses. The exclusion of Singapore family businesses from the sample is because we suspect there is minimal damaging influence on the capital market development coming from these family businesses. These conjectures are developed based on the fact that these firms are very much influenced by the government of the Singapore (Lim, 1983). Thus, for these firms there is a close guidance by the authority. Inevitably the close guidance by the authority and the presence of multinational firms in that country may result in good governance of family businesses there. Therefore, the detrimental family business effect on capital market development, as proposed imminent for the rest of the sample countries may not be present in the case of Singapore family businesses (Khan, 2006).

The capital market development indicator contains three stock market development indicators, namely, stock market capitalization (as percent of GDP), total share value traded

(percent of GDP) and number of companies listed (percent of population in million). The sources are from Beck *et al.* (2004) and the World Development Indicators (WDI). Obviously, each of these capital market development indicators describes a different characteristic of capital market development and has its own strengths and weaknesses. Among these indicators, in our opinion, ‘number of companies listed’ is probably the best to measure the capital market development, as it reflects the degree of access to the capital market by new companies. This is consistent with the view proposed in this study that family businesses blocked the rising of new businesses that could pose a threat to them, by distorting the development of the capital market. The more distorted the capital market is, the harder it is for the companies to acquire the necessary funding and this evidently could limit entrances of new companies.

Annual data on family influence is computed based on the total assets of family-owned companies listed on the stock exchange divided by the overall listed companies’ total assets. Numerous studies, such as Morck *et al.* (2001), have employed this as proxy for family ownership. The family-controlled companies are identified based on the study of Claessens *et al.* (2000). The dataset of total assets of the companies listed for each country was obtained from the *Datastream*.

Annual data on real GDP per capita (in US dollars), based on the year 2000 constant prices, was gathered from the WDI. The capital flows variable is measured by the gross private capital inflows to GDP was also collected from the WDI. The law and order is from the *International Country Risk Guide (ICRG)*—a monthly publication of Political Risk Services (PRS). This variable assesses the strength and impartiality of the legal systems, as well as the popular observance of the law. The law and order variable is scaled from 0 to 6, where higher value implies better rule of law.

Table 1: Mean of Dataset Used in the Analysis – 1986-2003						
Mean	Indonesia	Malaysia	Thailand	Philippines	Unit of Measurement	Source
Family Ownership	0.4211	0.1364	0.1837	0.8188	% of Total Asset	Datastream
Stock Market Capitalization	0.1572	1.4766	0.4023	0.4335	% of GDP	Beck <i>et al.</i> (2003)
Total Share Value Traded	0.0646	0.6649	0.3143	0.1100	% of GDP	Beck <i>et al.</i> (2003)
Number of Companies Listed	0.9913	25.132	5.5611	2.7806	% of (million) population	WDI
Real GDP Per Capita	726.24	3199.65	1744.79	930.79	Dollars at 2000 prices	WDI
Private Capital Flows	5.92	12.48	12.22	18.93	% of GDP	WDI
Law and Order	2.77	3.83	4.41	2.5	Scaled 1 to 6	WDI

Table 1 presents the mean values of the dataset used in the analysis from 1986 to 2003. Among these four ASEAN countries, Malaysia has the least family influence in the stock exchange, whereas the Philippines have high family influence concentration, followed by Indonesia and Thailand. In terms of capital market development, Malaysia has the highest stock market capitalization, total share value traded and number of companies listed compared to Indonesia, Thailand and the Philippines.

Table 2 presents the correlation results of the variables. As shown in Table 2, the family influence has a negative correlation with the three capital market development indicators. This implies that higher family influence is associated with low development capital markets. Besides, the family ownership has a negative relationship with real GDP per capita, law and order, and trade openness. On the other hand, family ownership has a positive association with private capital flows. The capital market development indicators are also positively correlated with one another, where the correlation coefficient ranges between 0.59-0.85.

Table 2: Correlation Results							
	<i>OWN</i>	MC	TVT	NC/POP	<i>RGDP</i>	<i>LO</i>	<i>PCIF</i>
<i>OWN</i>	1.00						
MC	-0.28	1.00					
TVT	-0.30	0.85	1.00				
NC	-0.45	0.82	0.59	1.00			
<i>RGDP</i>	-0.55	0.82	0.65	0.96	1.00		
<i>LO</i>	-0.36	0.40	0.47	0.26	0.40	1.00	
<i>PCIF</i>	0.23	0.26	0.18	0.08	0.10	0.08	1.00
Note: <i>OWN</i> = Family Ownership; MC = Stock Market Capitalization; TVT = Total Share Value Traded; NC = Number of Companies Listed; <i>RGDP</i> = Real GDP Per Capita; <i>LO</i> = Law and Order; <i>PCIF</i> = Private Capital Flows.							

Estimation Results

Table 3 reports the empirical results of Equation 1 utilizing three alternative proxies for capital market development. The Breusch Pagan *LM* test results reveal that there are country-specific effects in the data. The Hausman test statistics reveal that fixed effect models are more appropriate than random effect models. In Model 1, the real GDP per capita, law and order, and private capital flows variables are positive and statistically significant determinants of stock market capitalization. Nevertheless, the family business influence is negative and highly significant determinant of stock market capitalization. In Models 2 and 3, the family ownership also enters with a negative and significant specifications, while law and order and real GDP per capita are statistically significant in influencing the total share value traded and number of companies listed, in Models 2 and 3 respectively. On the whole, this finding suggests that greater family influence has a negative impact in determining the development of capital market, which is in line with the argument posed by Morck *et al.* (2001) and Johnson and Mitton (2002) that describes how dominant families prefer dysfunctional capital market as that will limit the number of new entrances.

Table 3: Results of Fixed Effect Models Dependent Variable: Capital Market Development ($\ln CD_{it}$)			
Dependent Variable	Model 1	Model 2	Model 3
	$\ln CD = \text{Stock Market Capitalization}$	$\ln CD = \text{Total Share Value Traded}$	$\ln CD = \text{Number of Companies Listed}$
Constant	-11.43 (-3.21)***	-12.96 (-2.23)**	-10.01 (-6.68)***
$\ln RGDP_{it}$	1.43 (2.59)**	1.13 (1.26)	1.39 (6.00)***
$\ln OWN_{it}$	-0.80 (-4.51)***	-1.66 (-5.70)***	-0.37 (-4.96)***
$\ln LO_{it}$	0.68 (3.21)***	0.69 (2.03)**	0.01 (0.16)
$\ln PCIF_{it}$	0.50 (3.38)***	0.40 (1.65)*	0.06 (1.06)
Breusch Pagan LM Test	21.56 (<0.00)	23.54 (<0.00)	27.41 (<0.00)
Hausman Test	16.96 (0.0020)	19.70 (0.0006)	22.13 (0.0001)
Note: All models are estimated using the fixed effect estimations (Stata xtreg, fe command); N = 4, T = 18. The variables are defined as: CD = Capital Market Development; $RGDP$ = Real GDP Per Capita; OWN = Family Ownership Defined as Total Assets of Family Own Firms/Total Assets in the Stock Exchange; LO = Law and Order; $PCIF$ = Private Capital Flows. Figures in the parentheses are t -statistics, except for Wald Statistic and Hausman Test, which are p -values. Time dummies were jointly significant and are not reported here to save space. ***, ** and * indicate significance at the 1%, 5% and 10% levels respectively.			

The panel data estimation results with the interaction between family ownership, and law and order are reported in Table 4. The real GDP per capita is statistically significant at 1%

Table 4: Results of Fixed Effect Models Dependent Variable: Capital Market Development ($\ln CD_{it}$) (With Interaction Term Between Family Ownership with Law and Order)			
Dependent Variable	Model 4	Model 5	Model 6
	$\ln CD = \text{Stock Market Capitalization}$	$\ln CD = \text{Total Share Value Traded}$	$\ln CD = \text{Number of Companies Listed}$
Constant	-12.52 (-3.19)***	-14.78 (-2.31)**	-11.50 (-7.21)***
$\ln RGDP_{it}$	1.48 (2.66)**	1.23 (1.35)	1.47 (6.46)***
$\ln OWN_{it}$	-0.74 (-3.45)***	-1.49 (-4.24)***	-0.26 (-4.06)***
$\ln LO_{it}$	1.42 (1.26)	1.95 (1.05)	1.01 (2.18)**
$\ln PCIF_{it}$	0.51 (3.42)***	0.42 (1.71)*	0.08 (1.36)
$\ln OWN_{it} \times \ln LO_{it}$	0.18 (0.67)	0.31 (0.69)	0.25 (2.25)**
Breusch Pagan LM Test	10.95 (0.0009)	23.45 (<0.00)	25.89 (<0.00)
Hausman Test	11.70 (0.0391)	15.75 (0.0034)	48.63 (<0.00)
Note: All models are estimated using the fixed effect estimations (Stata xtreg, fe command); N = 4, T = 18. The variables are defined as follows: CD = Capital Market Development; $RGDP$ = Real GDP Per Capita; OWN = Family Ownership Defined as Total Assets of Family Own Firms/Total Assets in the Stock Exchange; LO = Law and Order; $PCIF$ = Private Capital Flows. Figures in the parentheses are t -statistics, except for Wald Statistic and Hausman Test, which are p -values. Time dummies were jointly significant and are not reported here to save space. ***, ** and * indicate significance at the 1%, 5% and 10% levels, respectively.			

and 5% significance levels. The law and order variable, however, is significant at the 5% level in Model 6, where the capital market development proxy is number of companies listed. The private capital flows variable remains a significant determinant of stock market capitalization. However, the newly included interaction term is significant at 5% level when capital market development is proxied by number of companies listed. Thus, our findings suggest that family ownership has a negative impact on the development of capital market, but better legal system and regulatory framework can reduce the depressing effect of family ownership, and can help improve the quality of capital market.

Conclusion

This study examines the impact of family ownership on capital market development in the four ASEAN economies using panel data analysis. The empirical evidence suggests that the presence of greater family influence in the stock exchange has a detrimental effect on capital market development. The results can be considered valid as three alternative capital market development indicators, namely stock market capitalization, total share value traded, and number of companies listed are used. Our findings also suggest that only with the improvement in law and order would this problem be rectified.

There are also indications that in the ASEAN countries the links between family businesses and regulations that safeguard the existence of the capital market development are extensive. Apparently, such relationship existed because legal and regulatory development of the capital market may have been impeded by the concentration of the family businesses wealth and the extensive link between these firms with the regulatory body either directly or indirectly (Morck *et al.*, 2001). Consequently, with the existence of such relationship, it implies that future legal and regulatory reforms that guarantee capital market development may not be independent of changes in family businesses concentration of wealth.

In terms of policy implications, this study suggests that reducing family influence, improving the law and order situation, economic development, and capital flows will encourage the development of capital markets in these four ASEAN economies.

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