Press Releases and News

Title: A case of creative destruction

Source: The Straits Times, Singapore

Date: 03 June 2009

Author: Prof Bernard Yeung

FALL OF GENERAL MOTORS

A case of creative destruction

By Bernard Yeung,
Kathy Fogel
& Randall Morck
FOR THE STRAITS TIMES

IN 1953, then chairman of General Motors (GM) Charles Wilson testified at a confirmation hearing to become United States defence secretary that his existing job would entail no conflict of interest since "what is good for the country is good for General Motors, and vice versa". Such country-corporation symbiosis exists in several countries with one or more landmark corporations: Maersk shipping symbolises Denmark's maritime history; Nokia marks Finland's new economy; Singapore Airlines is Singapore's iconic company. It is natural to link an economy's fortunes with that of its landmark firms.

This week, GM filed for bankruptcy protection. Is what is bad for GM bad for the US?

There are several arguments supporting Wilson's argument that country-corporate fortunes are intertwined. Large corporations prosper because they are well managed, and the wealth they create spills over to the economy. Large firms can provide job security, undertake high risk-high return investments, and better absorb advertising investments. Also, investments in innovation are worth more to large firms because such innovations can enhance the productivity of their large-scale operations. The dominance of large businesses enhances economic fortunes, thus heightening their dominance, which in turn fuels overall economic growth.

However, there are also arguments on the other side. The notion of creative destruction suggests that today's upstarts not only become tomorrow's behemoths, but also inspire a new generation of upstarts that eventually engage them. Routines develop slowly and firms caught in a routine tend to resist change. Why?

Because these routines allow firms to prosper by fitting themselves into prevailing conditions, including consumer preferences and production technologies. However, we live in a dynamic world. As conditions change, an economy needs upstarts with new routines to displace past winners. These arguments suggest that Wilson is wrong. The continued dominance of a few large firms does not necessarily portend well for economic growth.

Our research of leading businesses in 44 countries supports the validity of the creative destruction argument. We found that a stable list of large businesses is associated with slower growth. Countries whose roster of big businesses does not change often exhibit slower growth, slower productivity growth and slower capital accumulation than those who do. Total per capita gross domestic product growth and total factor productivity growth are negatively correlated with corporate stability.

Interestingly, this negative association prevails regardless of a country's size. Both small and large economies demonstrate the creative destruction effect.

We also took into account the industrial structures of the economies. Dependence on natural resources may affect big business stability and economic growth. Resource-abundant countries could have long-lived resource extraction businesses that remain large so as to exploit economies of scale. Yet, for political and institutional reasons, these countries may have remained poor. However, our study showed that resource dependency did not affect our findings.

Does the size and quality of the government play a role? A benevolent interventionist government may view enhanced corporate stability as a tool for stabilising employment and promoting egalitarian goals.

Our research showed that the size of government is related to business stability. Big businesses melt away less often when governments are large, red tape is dense and big banks are dominant.

In high-income countries, slow growth correlates with a more stable, large private sector of non-financial firms. In contrast, slow growth in low-income countries is linked with the persistent dominance of a cadre of state-controlled enterprises, suggesting that there may be a drag on growth resulting from state intervention.

The fall of GM may be a good thing in disguise. Economic growth is linked to the demise of big old businesses, not merely the rise of new ones. Sustained long-term growth entails new corporate giants arising and undermining old leviathans. Growth due to innovation by large established businesses appears less important, especially in recent decades.

Countries therefore need to be mindful that big businesses may become excessively stable and retard growth. Governments should continually encourage new businesses to challenge existing ones and spur them to greater heights. Corporations should continually metamorphose themselves into different entities or engage in different strategies to adapt themselves to changing external landscapes. The Singapore Government's effort to encourage entrepreneurism and creativity is a step in the right direction.

Bernard Yeung is dean of the NUS Business School. Randall Morck is a professor at the University of Alberta and the National Bureau of Economic Research. Kathy Fogel is an assistant professor of finance at the University of Arkansas.