

There are financial, managerial and operational links between horizontal *keiretsu* firms. In addition, presidents of the major member firms meet regularly, although the importance of such meetings, as measured by the amount of business conducted at them, is subject to some debate.⁴²

- Financial Links

Financial links within horizontal *keiretsu* include both debt and equity financing. Banks provide most of the debt financing in the form of loans, while manufacturing and international trading firms provide trade credits to other *keiretsu* firms. From the point of view of the firm providing the financing (usually a commercial bank), such arrangements provide it with extensive input into the operations of the financed firms. From the point of view of the financed firm, there is a tax advantage associated with borrowing, since interest expenses are deductible from gross revenue, and thus reduce the amount of tax payable. Dividends on equity issues are paid out of after-tax income.⁴³

In addition to the tax advantage, a number of other incentives have favoured debt over equity financing in Japan. The incentives have been based on corporate ownership structures and institutional financial arrangements, and include the reduced cost of financial distress and reduced agency costs.⁴⁴ As a result, Japanese firms typically have been more highly leveraged than U.S. firms.⁴⁵ Moreover, the borrowing of Japanese firms has been more concentrated, especially for *keiretsu* members.⁴⁶

⁴² See E. Razin, *op. cit.* pp. 371-2. The meetings are generally held in secret, and are regarded by some participants as little more than social gatherings.

⁴³ The tax system also favours debt over equity in North America.

⁴⁴ See W.C. Kester, *op. cit.*, pp. 5-9; and A.B. Frankel and J.D. Montgomery, "Financial Structure: An International Perspective", in *Brookings Papers on Economic Activity*, 1, W.C. Brainard & G.L. Perry, eds. Brookings Institution, Washington, D.C., 1991, pp. 287-91.

⁴⁵ For summary statistics on debt/equity ratios for a sample of 344 Japanese firms and 452 U.S. firms, see W.C. Kester, *op. cit.*, p. 11. Using book value equity, the average Japanese debt/equity ratio was 1.91, and the average U.S. debt/equity ratio was 0.58. Using market value equity, the average Japanese debt/equity ratio was 0.98, and the average U.S. debt/equity ratio was 0.69.

⁴⁶ See S.B. Kim, "The Use of Equity Positions by Banks: The Japanese Evidence", in *Economic Review*, No. 4, Federal Reserve Bank of San Francisco, San Francisco, CA, Fall 1991. p. 44. Kim claims one of the objectives of Japanese authorities in the 1970s was to make industrial financing the almost exclusive preserve of Japan's financial institutions, and to limit their number by strict entry