Business Groups in Comparative Perspective

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(based on past work with Tarun Khanna, HBS)

What are BGs?

- Business Groups are ubiquitous (Korea, Thailand, Malaysia, Brazil, Argentina, Mexico, India, Italy, Belgium, Sweden…).
- Diverse (scope of activities, control structure, interactions with government and society).
- Common feature: legally independent entities, operating across industries, bound by formal and informal ties, often family ownership, varying degrees of outside participation.
- (Unlike conglomerates or franchises).

Literature on BGs

- Two dominant perspectives: groups as diversified entities (early); and groups and "tunneling" (later; conflicts between controlling and minority shareholders).
- Some literature on rent-seeking (lobbying/ political economy of groups) and a bit of IO/monopoly power .
- [Outside economics/finance: sociology lit on networks.]

Tentative Claim

- The overall welfare effects of groups are hard to judge (multiple effects, unknown counterfactual).
- But: the “good” things that groups may do tend to happen in early stages of economic development; the “bad” things tend to persist long afterwards.
- In fairly developed economies groups can cause significant damage and policy makers should consider measures to limit this damage.

Why Groups May be Welfare Enhancing

- Some BGs outside the US perform well, in contrast with the evidence on diversified entities in the US
- Claim: BG’s can make up for missing institutions? (which ones? K vs. L markets? Entrepreneurship?) – good for social welfare.
- Diversified BGs perform well for bad reasons (monopoly power, rent seeking).

Implications for Developed Economies

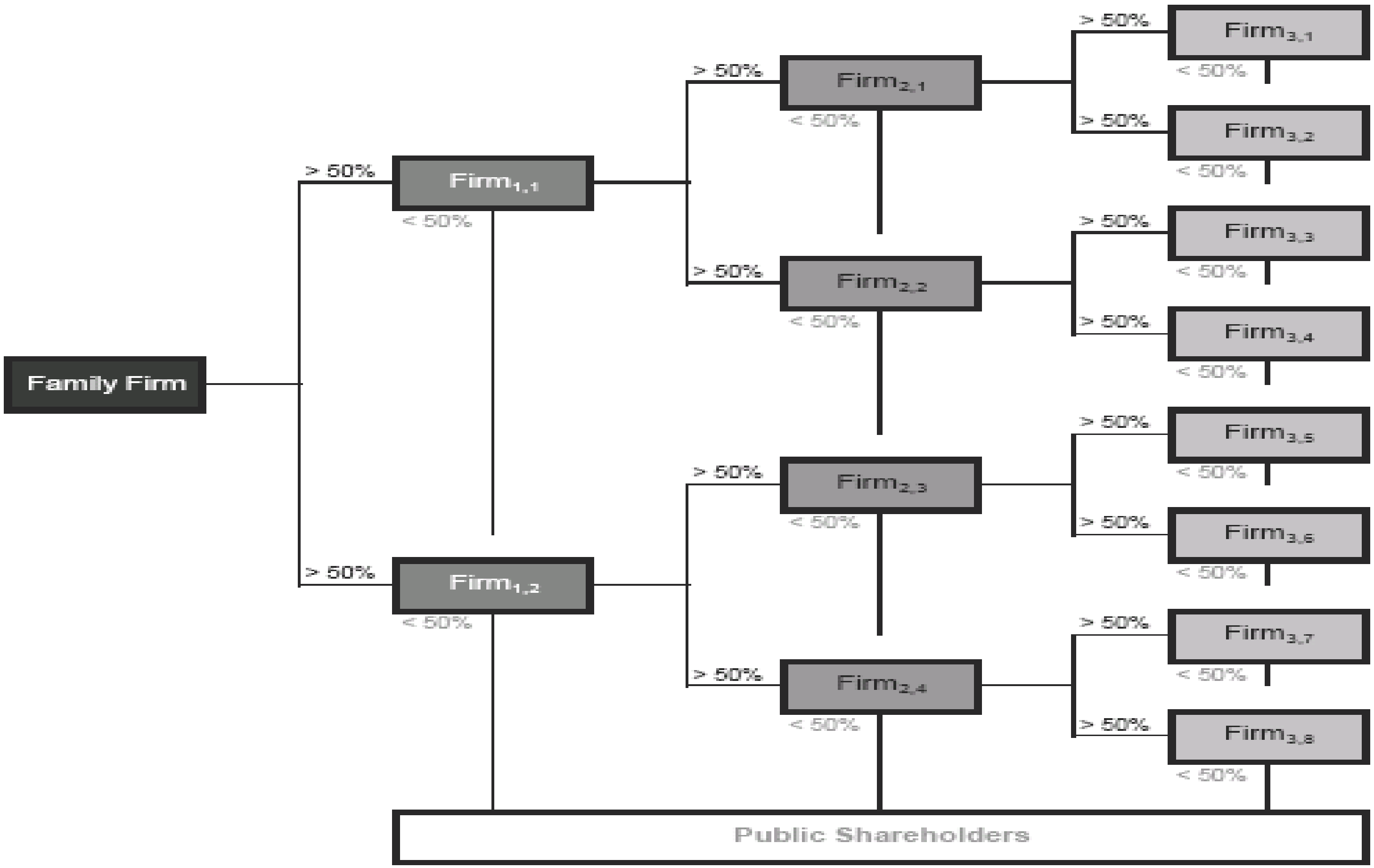
- Subject to some conceptual and econometric difficulties:
- *If* groups help economic development, the evidence suggests that this happens in primarily in early stages.
- The “missing institutions” argument is implausible in the case of economically and institutionally developed countries.
- (Open question: groups as VC-substitutes in some non-Anglo Saxon countries).

Pyramidal BGs, Corporate Governance, and Tunneling

- Vertically controlled pyramids can be used as a mechanism to expropriate minority shareholders.
- Tunneling associated with divergence between “cash flow rights” and “control rights.”

Figure 1. A Stylized Control Pyramid

A family firm controls a first tier of firms with dominant voting stakes, in this case greater than fifty percent. Each first tier firm controls several second tier firms, each of which controls yet more firms. The overall effect is to extend the family's control to encompass assets worth substantially more than its actual wealth.



Evidence on Tunneling

- Huge literature following LLSV.
- Pyramids and family control frequently observed where investor protection is low.
- Very convincing papers on expropriation of minority shareholders by BGs in India (Bertrand et al) and Korea (Bae et al and Joh) + many others. Some evidence also from Continental European countries.

Tunneling –contd.

- Why do investors accept this deal?
- naïve?
- Limited options?
- Group reputation for bailouts, for lobbying, or for treating small investors fairly?
- Tunneling as a return to some group asset?

(implausible in developed economies?)

- Tunneling adversely affects financial development.

BGs as Family Firms

- Many BGs are Family Firms – that is, controlled by a founding family with varying degrees of participation by outside investors.
- One systematic study of ethnic Chinese groups in Thailand + anecdotes on family and succession issues in BGs in Korea, India and other countries.
- In family firms, performance tends to deteriorate with the transition to the 2nd generation.
- Large BG's involve large-scale risks associated with mismanagement in the 2nd generation.

BGs and Government

- Little doubt that groups all over the world and throughout the last 130 years were formed with various degrees of government support (Table IV in Khanna and Yafeh, 2007).

Evidence on Groups and Politics – "Entrenchment"

- But on-going relations between groups and governments more complex and less one sided: Indian government in certain phases; Chile; Samsung in Korea…
- Evolution over time: e.g. changing relations between the Japanese government and the zaibatsu (1880s to 1930s); The chaebol in the 1980s vs. earlier decades.

How Do Groups Shape Their Environment?

- Some positive examples:
  - Group support in Mexico for NAFTA;
  - Some group support for liberalization in India.

- Also other cases:
  - Opposition to corporate governance reforms in Korea;
  - Direct involvement in politics (e.g. Italy, Korea, Thailand);
  - Influence on the media (Italy), and
  - "Entrenchment" in general: virtually impossible to dissolve established groups.

BG’s and Monopoly Power

- Collusion (multi-market contacts);
- Entry deterrence/predation (“deep pockets,” vertical foreclosure);
- Bundling/tying of products;
- Regulatory capture.

Some supporting evidence from France;

Some anecdotes (on profit rates or turnover of groups in some countries);

Overall limited body of academic research.

Implications for Groups in Developed Economies (Repeated)

- Current groups in most OECD countries operate in an institutionally developed environment – "missing institutions" arguments unlikely.
- But the welfare reducing arguments about groups are very likely to be relevant:

  -"Tunneling" and impediments to financial development;

  - "Entrenchment" and rent seeking;

  - Monopoly power;

  - Mismanagement associated with the second generation of family firms.

Policy toward Business Groups

- In principle, all aspects of group activity should be analyzed jointly.
- Some idea of the counterfactual (what will happen without them) should be formulated.
- What policy tools to use? “Containment” probably more feasible than active dissolution.
- Containment tools: stronger/wider anti-trust laws or taxation of intra-group transfers.
- My personal preference: Tend to favor anti-trust legislation as a policy tool.

For Example…

- Large groups should not be allowed to acquire control of a financial institution ("related lending" is risky plus ability to push rivals).
- Antitrust considerations could include overall economic power, not only industry-specific market structure.