



Should business groups be dismantled? The equilibrium costs of efficient internal capital markets ☆

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Abstract

We analyze the relationship between conglomerates' internal capital markets and the efficiency of economy-wide capital allocation, and we identify a novel cost of conglomeration that arises from an equilibrium framework. Because of financial market imperfections engendered by imperfect investor protection, conglomerates that engage in winner-picking (Stein, 1997 [Internal capital markets and the competition for corporate resources. *Journal of Finance* 52, 111–133]) find it optimal to allocate scarce capital internally to mediocre projects, even when other firms in the economy have higher-productivity projects that are in need of additional capital. This bias for internal capital allocation can decrease allocative efficiency even when conglomerates have efficient internal capital markets, because a substantial presence of conglomerates might make it harder for other firms in the economy to raise capital. We also argue that the negative externality associated with conglomeration is

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particularly costly for countries that are at intermediary levels of financial development. In such countries, a high degree of conglomeration, generated, for example, by the control of the corporate sector by family business groups, could decrease the efficiency of the capital market. Our theory generates novel empirical predictions that cannot be derived in models that ignore the equilibrium effects of conglomerates. These predictions are consistent with anecdotal evidence that the presence of business groups in developing countries inhibits the growth of new independent firms because of a lack of finance.

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1. Introduction

During the 1990s business groups in developing countries, and especially in East Asia, were under pressure to restructure. Although widely regarded as the engine of economic growth in earlier decades, business groups are now blamed by politicians and commentators for the economic problems (slow growth, financial crises, etc.) affecting some regions of the world. Those against the busting up of business groups contend that these organizations substitute for missing markets (Khanna and Palepu, 1997, 1999). For example, the presence of business groups could improve economic efficiency because their internal capital markets allocate capital among member firms more efficiently than the underdeveloped external capital market does (Hoshi et al., 1991; Khanna and Palepu, 1997; Stein, 1997; Perotti and Gelfer, 2001). In contrast, those in favor of dismantling business groups argue, among other things, that business groups inhibit the growth of small independent firms by depriving these firms of finance. (See, for example, *Financial Times*, 1998, for an account of the difficulties that independent firms faced in obtaining finance before the reform of the Korean chaebols.)

Existing models of internal capital markets consider conglomerates in isolation, abstracting from the effects that conglomeration might have on other firms in the economy (see Stein, 2003, for a survey of the literature on internal capital markets).¹ However, the argument that conglomeration makes it harder for small independent firms to raise financing is directly suggestive of such externalities. Is it reasonable to expect that a high level of conglomeration hampers the allocative efficiency of the external capital market? If this conjecture were true, it would give rise to important welfare and policy implications. For instance, even if conglomerates' internal capital markets were efficient (in the sense that conglomerates allocate capital to divisions

¹We use the terms “conglomerate” and “business group” interchangeably. Although these organizations are different in many respects (for instance, a business group is formed by legally independent firms and a conglomerate is typically a single firm with multiple divisions), they both have internal markets that allocate capital among the member firms in the case of business groups (Samphantharak, 2003) and among divisions in the case of conglomerates (Lamont, 1997).

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