A comparative political economy of diversified business groups, or how states organize big business

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Abstract. Diversified business groups are present in nearly all economies and dominate the private sector in most developing countries. This article seeks to add to existing theories, primarily economic and sociological, by analyzing the policies and state actions that promote and sustain business groups, and contribute to significant cross national variations among them along dimensions of size, range of diversification, and reactions to globalization. The political economy explanation presented here emphasizes the role of politics and policy -- especially regulatory policies and overall development strategies -- in setting the external parameters of variation among groups, and also incorporates additional internal economic logics (economies of scope and risk reduction). This political economic approach helps distinguish the core logics of three main kinds of business groups -- organic, portfolio, and policy-induced -- that have reacted differently to recent trends in market reform and globalization.
**Introduction**

Known by a variety of local monikers like *grupo económico*, *chaebol*, business house, conglomerate, *jituanqiye*, mining finance house, or FIG (financial industrial group), the diversified business group has been a pervasive, though often neglected, feature of modern capitalism for the last century or so and crops up in contexts as diverse as India, Sweden, South Africa, Bulgaria, and the United States. In fact, diversified business groups have been the predominant form of organization among the largest domestic firms in many countries of the world, especially developing countries. By one count, among the 50 largest firms in developing countries in 1993, there were 31 diversified groups, 8 state-owned enterprises, 7 foreign multinational corporations (MNCs), and only 4 specialized private firms (Amsden 2001, 197–99).

Over the past decade, sociologists, economists, and management specialists have generated a growing literature on diversified business groups (political scientists have been conspicuously absent). Three general approaches can be distilled out of this literature, each with its own distinctive disciplinary perspective, theoretical puzzles, and associated definitions (on which there is as yet no general, inter-disciplinary consensus). Sociologists often take the broadest view of business groups and include both formal ownership groups as well as more loosely connected informal groups, Japanese keiretsu prominent among them. Informal business groups are of particular interest and pose the core theoretical puzzle of what non-contractual ties bind these voluntary groups together (see Granovetter (2005)).

Scholars of corporate governance and management are less interested in informal connections and concentrate instead on the nature of ownership relations within formal business groups that have controlling owners, usually a small set of very wealthy families (for comprehensive reviews, see Morck, Wolfenzon, and Yeung 2005; Khanna and Yafeh 2007, 343–51). The key issue here is pyramidal ownership structures, where group owners use small amounts of equity to control much larger corporate assets through complicated mechanisms such as multiple tiers of firms, cross shareholding, and non-voting shares. In these analyses, the core
theoretical issues are how and why these groups maintain such concentrated control, and the main practical concerns revolve around transparency, expropriation of minority shareholders, and the overall health of equity markets.

A third focus, especially among economists, is on ownership concentration and sectoral diversification, and often highlights the absence of particular markets or institutions in promoting group formation. Leff’s (1978) pioneering work argued that groups internalized capital market functions and substituted for shallow financial markets in developing countries. According to Mauro Guillén’s (2001) resource-based approach, groups arise in contexts of asymmetric flows of international trade and investment. Drawing on transaction cost economics, Tarun Khanna and Krishna Palepu (1997) hypothesize that groups may substitute for other informational intermediaries (consultants, head hunters, analysts, etc.). Other economic approaches develop arguments based on economies of scope where business groups develop generic expertise that can be profitably applied in multiple sectors (Amsden 2001).

Despite recent gains in theoretical and empirical work, several important areas have been neglected. First, the state and politics, though often mentioned, are rarely incorporated in more systematic and comparative analysis of business groups. Second, attempts to account for patterns of diversity among business groups are incipient (Granovetter 2005; Khanna and Yafeh 2007), and many general arguments gloss over the fact that groups vary enormously cross nationally and often within countries as well. To take one contrast, to which I return, Korean chaebol are huge and diversified into a loosely related set of core manufacturing activities, while most business groups in Latin America are much smaller and spread across a less connected set of business activities in services and commodity production. If such differences are important to understanding the causes and consequences of business group dominance, then theorizing needs to incorporate more causal heterogeneity.

Among the business groups studied here, the crucial dimensions of variation in group governance are: size, scope of diversification, and recent reactions to market reforms and globalization. To understand these different patterns in business group evolution, my political
economy approach starts with politics and policies that set the broad parameters of variation, in particular how state actions favor (or inhibit) diversified groups, both intentionally and unintentionally.\(^3\) Intentional government support for particular kinds of groups includes: 1) promotional policies that help firms grow large, discriminate in favor of national firms, push leading firms to branch out into new activities, or shift state firms to the private sector (privatization); and 2) regulations on mergers and acquisitions (anti trust), banking (especially equity holdings in non-financial firms), and the entry and activities of MNCs and state owned enterprises. Furthermore, other goals and policies that states pursue, tariff protection and joint venture requirements for MNCs, for example, have the collateral effect of promoting group diversification (Guillén 2001). Even more unintentionally, weak law enforcement and political instability exacerbate uncertainty and encourage broader group diversification.

These multiple political factors establish the broad constraints (or lack thereof) on the growth and diversification of business groups. Within these political parameters, additional economic factors are also at work. One factor is economies of scope where groups leverage expertise in generic activities like project execution, marketing, or logistics into increasing returns to diversifying into new sectors (Amsden 1989; Amsden 2001). A second economic approach views diversification as a group strategy to reduce risk and manage volatility. These internal economic logics illuminate group strategies, especially on the diversification dimension, but they are embedded in broader political contexts that provide opportunities, for example, for developing particular economies of scope or that generate risks and uncertainties for groups.

For my purposes, a diversified business group is a set of legally distinct firms that operate in three or more unrelated business activities and that are subject to centralized control, usually through significant equity holdings or other financial connections. This definition excludes firms that have multiple production facilities within the same corporation as well as looser informal networks of firms (such as keiretsu) that may coordinate some activities but are not subject to centralized control.\(^4\) My typology of organic, portfolio, and policy-induced groups is based on
strategies of diversification, and therefore brackets other issues of ownership and corporate governance.

The prominence and resilience of business groups raises the possibility that they form part of a ‘variety of capitalism.’ The conclusion returns to this question, but at the outset suffice it to note that most business groups would not fit well, or complement, either main category of liberal market economy (LME) or coordinated market economy (CME). Nearly all business groups have controlling owners which is quite different from the dispersed ownership characteristic in LMEs. Among CMEs, Hall and Soskice (2001) do define Japan as a subtype of group-based coordination, as opposed to industry-based coordination in Germany. However, Japanese groups, keiretsu, engage in informal, horizontal coordination (and as such are excluded from my definition of business groups). Similar informal business groups have rarely emerged elsewhere, and the groups discussed here are all hierarchical corporate forms where central owners direct rather than coordinate.5

The empirical analysis that follows is largely qualitative and covers a wide variety of countries, both developed and developing, and where relevant highlights regional contrasts between Latin America and Asia.6 Section II examines large variations in size, many of which can be traced back to government policies designed to promote or restrain groups. Section III analyzes different patterns of diversification (organic, portfolio, and policy-induced) through a combination of internal economic logics and external political constraints and opportunities. Section IV reviews the varying responses of groups to the pressures and opportunities of globalization and ties these responses in many instances to prior differences in size and scope. Politics matters in each of the sections, though in different ways. The goal is to identify the multiple, usually complementary political and policy impacts on group structure rather than to establish a single political cause. The conclusion considers some further theoretical issues and questions for research.

II. Variations in Size
Business groups vary in terms of their combined size in their respective economies as well as compared to one another cross nationally. There is some tendency for larger groups in cross national comparisons to come from larger economies, especially within Latin America, though some very large groups emerged in small countries like Singapore and Sweden, and the largest groups from developing countries come from medium sized Korea (Amsden 2001). A stronger relationship to geography emerges when the measure is the share of GDP; business groups in smaller countries tend to account for a larger share of their smaller economies. Although the number of cases is small, the average share of GDP accounted for by the top ten groups in smaller countries in Table 1 is over twice the average share of groups in larger countries.

Table 1 about here

Beyond country size, the major explanations for variation in group size are political and policy related. In Table 1, the average share of GDP for the largest Asian groups is nearly double the share of Latin American groups. A first explanation focuses on policy and development strategy. In the 20th century, export promotion policies in East Asia allowed firms to grow, while ISI (import substituting industrialization) in Latin America limited the markets groups produced for. Moreover, as discussed below, policies promoting the large presence of MNCs and state enterprises in Latin America further restricted opportunities for groups there to expand. Lastly, Amsden (2001, 225–32) argues that greater levels of inequality in Latin America (compared to East Asia) reduced popular support for large groups and prompted governments to restrain their growth.7

Politics were also decisive in the intra-regional contrast between Korea and Taiwan where the top ten groups accounted for, respectively, 49 and 19 percent of GDP (Table 1). Korean governments from the 1960s to 1980s actively promoted huge groups while the Taiwanese government worked to limit their size (Fields 1997). In the 1960s, the military regime
in Korea explicitly encouraged the emergence of giant groups. President Park wrote in 1962, “Mammoth enterprise -- considered indispensable, at the moment, to our country -- plays . . . a decisive role in economic development ...” (Amsden 1989, 50). In Taiwan, in contrast, the Kuomintang harbored suspicions about inordinate business power and deliberately worked to limit the development of huge business groups (though smaller, leading Taiwanese groups were diversified and family controlled).8

Government policy is also central to understanding instances where diversified businesses do not account for much of the GDP, as in the United States. Before the 1930s, pyramidal business groups were common, but the Roosevelt administration introduced new tax laws that effectively eliminated them (Morck 2004). Later, the large firms embarked on a wave of conglomereration that peaked in the 1960s and 1970s before shifting to strategies of specialization after 1980. This rapid rise and decline was also in large measure a response to state actions. The Federal Trade Commission originally interpreted anti-trust legislation in ways that ruled out mergers in firms’ own markets and pushed them instead to diversify (Fligstein and Freeland 1995, 34). Reinterpretations of anti-trust law in the 1980s opened up more opportunities for buying up competitors which then became more common (Fligstein 1991). In addition, securities analysts, hostile takeover firms, and large institutional investors forced further specialization (Zorn, Dobbin, et al. 2006). By the 1990s there were few business groups or conglomerates left in the United States.

In sum, beyond some geographic factors, remaining large differences in size can usually be traced to government actions. A wide variety of policies, backed by diverse political motivations, can promote or inhibit the growth of business groups. The point to highlight for now is that the influences are nearly all political and policy related.

III. Variations in Diversification

Although difficult to measure precisely, the patterns of, and motivations for, diversification vary substantially across countries, and sometimes within countries as well.9 This
section reviews two main economic incentives for diversification -- economies of scope and risk reduction -- as well as policy measures that directly or indirectly encourage diversification. After considering these incentives, and corresponding types of groups (organic, portfolio, and policy induced), the analysis turns to the government imposed, external limits on group diversification.

Economies of scope offer business groups opportunities to transfer existing organizational models, market strategies, and experienced personnel to new activities in ways that tend to flatten learning curves and reduce costs. Korean chaebol found economies of scope in the process of licensing production technologies and starting up new plants to use them (Amsden 1989). The teams that worked in executing one project could then be mobilized to implement the next one. The sharing of “management know-how” was crucial for the chaebol overall and especially when entering new businesses (Chang 2003, 90). Other diversified firms generate expertise in multiple sectors where new products have long gestation periods and high development costs. So, for example, General Electric and Siemens both produced complicated, costly machinery like locomotives, jet engines, and electric turbines. Other groups find economies of scope not on the front end of product development but rather on the delivery end. Proctor & Gamble has economies of scope in branding, marketing, and managing relations with advertisers and retailers that can lower costs across a range of different products. Similarly, groups that produce outputs that are measured in millions of tons such as processed metals (e.g., steel, aluminum, or copper), cement, and other minerals, develop expertise in bulk logistics that can be applied to a variety of commodities. The Brazilian group Votorantim, for example, produces cement, aluminum, pulp and paper, and orange juice. The production technologies and markets for these products are completely different, but production in each case requires figuring out how to transport and process millions of tons of inputs and outputs.

A second main economic motive for diversifying is risk management where business groups seek out subsidiaries that are subject to different market cycles. Historically this was a major motivation for diversification in Turkish groups (Bugra 1994, 188). In Brazil, by the
2000s groups were using sophisticated computer models to calculate precisely how counter
cyclical investment in a new sector might be, as well as generate an overall indicator of a group’s
protection from market volatility (interview with manager at Camargo Correa, 2 August 2006).
In contrast to economies of scope, risk reduction leads groups to diversify into sectors that are as
unrelated as possible, like hotels and mining, or steel and cattle. Risk reduction is a stronger
incentive in groups with core activities subject to greater price and demand fluctuations like raw
materials, industrial commodities (metals), construction, and capital goods. For example, in
announcing in 2005 the establishment of a construction subsidiary, Juan Rebelledo, the vice
president of the huge mining firm Grupo México, explained that, “the construction firm has the
advantage, the same as with the railroad firm [another subsidiary], of being counter cyclical to
copper, so that when the prices of that metal go down a lot, these firms can provide liquidity, and
that is the advantage of having a relatively diversified and controlled portfolio” (La Reforma
online, 23 August 2005).

Beyond market fluctuations, politics can also be a major source of uncertainty both on
macro economic policy and political instability overall. Volatility has generally been much
higher in Latin America than in Asia and Europe (IDB 2003, 116, 133), which gives groups in
Latin America stronger incentives for unrelated diversification. Similarly, an in depth study of
Turkish groups found that “the concern for risk, ..., is related to the erratic character of the policy
process which was depicted by the overwhelming majority of my interviewees, as the most
significant characteristic of the Turkish business environment” (Bugra 1994, 188). Even in the
United States, high risk, high vulnerability tobacco companies like Philip Morris (later Altria)
and Reynolds (also known briefly as RJR Nabisco) were swimming against the
degglomerination tide in the 1980s and acquiring unrelated subsidiaries, especially in food and
beer.

Beyond these economic incentives to diversify, policy makers sometimes directly push, or
entice, groups into new sectors. For Turkish groups, “the decision to enter into a new area of
activity is often taken via suggestions and recommendations of government authorities rather
than through an evaluation of market signals” (Bugra 1994, 187). When in the 1970s the Park regime in Korea embarked on the plan to promote Heavy and Chemical Industries (HCI), planners called on existing chaebol to take the lead in developing new sectors. The government “chose Hyundai and Daewoo to develop power plant facilities and Hyundai, Samsung, and Daewoo to build ships” (Chang 2003, 54). In Latin America, when governments decided in the 1990s to privatize huge state enterprises, the only buyers with sufficient resources were local business groups or MNCs, and governments often preferred domestic buyers (Manzetti 1999). In more diffuse fashion, new tax incentives in Taiwan in the 1960s encouraged firms to establish new firms rather than expand existing ones, and these new firms had lasting effects on the structure and diversity of Taiwanese groups for decades afterwards (Chung 2001). Other policies provided more indirect incentives for diversification. Under ISI, for example, firms rarely exported, so once domestic markets were saturated in particular product lines, firms had no where to invest but in new sectors.

These various economic and political motives can be recombined to distinguish conceptually among three ideal types of diversified business groups: organic, portfolio, and policy-induced (see Table 2). Organic groups, develop largely according to the logics of economies of scope and vertical integration, and their subsidiaries are thus likely to have stronger synergies in organization, personnel, and expertise. New investments are more likely to be greenfield plants, especially as firms extend their economies of scope. For example, from 1938 to 1993, Samsung created 62 new firms, nearly double the number it acquired, and most of the acquisitions came in the early decades and the establishment of new firms in the later decades. Moreover, many of the acquisitions were horizontal while the creation of firms was in new sectors (Kang 1997, 37). Forays into new sectors through greenfield investment require long lead times and tend to occur incrementally and sequentially, and the resulting subsidiaries are likely to remain in the groups for long periods or forever. Management connections across member firms tend to be denser and closer, especially in instances of economies of scope that rely on the transfer of personnel among subsidiaries.
Table 2 about here

**Portfolio groups** diversify to manage risk and maximize returns in the market for corporate governance (buying and selling firms). Managing risk tends to focus the attention of owners of groups in more volatile sectors or countries while opportunistic acquisitions are likely to inform group strategies in more stable environments. Portfolio groups are more likely to buy firms rather than build them from the ground up and to spin off firms if they run into trouble. Bank-centered groups naturally tend to develop as portfolio groups. Because portfolio groups often expressly buy subsidiaries in sectors completely unrelated to core group firms, the technological incentives to integrate management are lower, and group owners, especially in developed countries, often allow subsidiary managers considerable autonomy. However, broad diversification raises problems of agency and information asymmetries, especially in less competitive markets and in developing countries, that can encourage greater management integration (often through kinship networks).

Lastly, **policy-induced groups** diversify in response to government incentives or directives. As noted above, these policies can range from direct industrial promotion like the Korean HCI, to privatizations that draw firms into new sectors, to more indirect effects of tariff and other protections. This category would also include a subset of patrimonial business groups that arise in cases of purer political or crony capitalism under long standing personal dictatorships like Suharto, Marcos, or Somoza, where governments determine the structure of groups more directly by distributing concessions to family, friends, and supporters (see, for example, Rivera (2003) on the Philippines). Patrimonial groups may coexist with other groups; in Indonesia in 1996, the sales of “Suharto-linked groups” were nearly double those of “independent groups” (Hanani 2006, 188). In patrimonial groups, the pattern of diversification depends less on any market logic than on government created rents.
As ideal types, portfolio, organic, and policy-induced groups can be analytically distinguished, and countries or periods identified with the predominance of a particular type. In practice, however, some groups may mix these strategies by combining, for example, a core set of organic subsidiaries with another set of risk-balancing portfolio investments. In other cases, organic or portfolio groups may be induced by particular policies to enter new sectors, especially during periods of rapid policy change. Over time, individual groups may shift their predominant strategy. Samsung started out in the 1940s and 1950s under ISI as a bank-centered portfolio group, then shifted after the military government took away its banks to a more policy induced group, but along the way developed economies of scope in project execution that helped it shift by the 1980s and 1990s to an organic group focused more on electronics technologies (Kang 1997, 37–45).

Despite this empirical complexity, the typology is still useful in identifying broad trends or clustering across countries and periods. Table 3 shows some basic regional differences. By this quantitative estimate, business groups in Taiwan and Korea were less diversified than those in Southeast Asia and Latin America, and less likely to have financial subsidies. These data fit with the view that groups in East Asia, especially Japan, Taiwan, and Korea, have tended to be more organic and clustered in manufacturing sectors with greater economies of scope (Amsden 2001). In contrast, countries with long-standing personal dictatorships (as in some countries Southeast Asia and Central America) tend to generate more policy-induced, patrimonial groups, as do politicized processes of sweeping privatization (as in Chile (1970s), Argentina, and many countries of Eastern Europe. And, portfolio groups tend to predominate where groups grow out of banks or raw material commodities or in countries where volatility and uncertainty have been greater, as has been common in Southeast Asia and Latin America (Schneider 2008b). Although the number of cases is small, the data in Table 3 also suggest that groups with lots of assets in finance, like bank-centered groups, tend to be more diversified.

Table 3 about here
In sum, a range of economic and political factors affect incentives for groups to diversify. However, while many immediate, internal incentives may be economic (exploit economies of scope, balance risk, or reduce transaction costs), often behind them lie deeper political causes for the opportunities to exploit economies of scope (as in protected economies), sources of volatility (many of which come from government policy), and the weak legal and institutional environments that increase transaction costs.

The discussion so far has focused largely on internal logics of diversification. These internal logics are the primary, often exclusive, focus in much of the literature on business groups that consequently misses the crucial external constraints or parameters that decisively shape group structure. Government policies established significant external boundaries for group expansion by setting the terms of group interaction with MNCs, state enterprises, and banks. That is, where governments reserved certain sectors for state enterprises or MNCs, or put banks off limits, then groups had to find other areas into which they could expand.

Countries vary a great deal in terms of the sectoral distribution and proportion of the production accounted for by MNCs. Among developed countries, MNCs are rare in Japan, where they account for only two percent of sales, but more common in the United States and large countries of Europe where their sales range from 11 percent in Germany to 32 percent in France (Barba Navaretti and Venables 2004, 5). For most of the 20th century, Swedish governments of varying ideological persuasions imposed severe restrictions on foreign ownership to protect national groups from being taken over (Högfeldt 2004, 15). Among developing countries, governments excluded MNCs from many sectors in Korea and India but welcomed them in Latin America and Southeast Asia. In all these cases, government policy heavily conditioned, if not directly regulated, the presence of MNCs. For business groups, the most important impact of MNCs comes in terms of the opportunities they close off or leave open (Guillén 2001; Amsden 2001). In the formative decades of the 1960s and 1970s, the heavy presence of MNCs in Latin American manufacturing closed off opportunities and pushed
business groups into services and commodities, while the relative absence of MNCs in Korea left open more possibilities for chaebol expansion in manufacturing (Maman 2002). Of course, there is nothing automatic about groups taking advantage of opportunities, however, once MNCs are established in particular sectors, domestic firms tend to avoid direct competition.\textsuperscript{14}

State enterprises also closed off some opportunities for groups and expanded others. Cross regional variations were similar to MNC presence, with state enterprises typically occupying a larger slice of the economy in Europe and Latin America than in Asia. State enterprises in most countries were concentrated in public utilities, mining, oil, and other capital intensive manufacturing sectors like steel. Also, parallel to the story of MNCs, governments sometimes adopted policies where state enterprises had to invest together with domestic firms or buy inputs from local suppliers which also drew groups into new sectors (Evans 1979). Lastly, as discussed later, the eventual privatization of many state enterprises after the 1980s opened up previously closed options for group diversification.

Differences in banking regulation also had profound impacts on group evolution. Where banks faced few regulatory restrictions, they were usually core group enterprises. For example, the two largest groups in Sweden, the Wallenberg and Handelsbank groups, grew in the early 20th century out of their respective banks (Collin 1998, 726). In Latin America, through much of the 20th century, banks were pivotal in the formation and evolution of business groups. Similarly, the six largest Chinese-Filipino groups either started in finance or bought large financial firms after growing large in manufacturing (Rivera 2003, 95–7). And, four of the six largest South African groups in the 20th century either started in finance (especially insurance) or acquired major financial firms (Goldstein 2000, Table 1).\textsuperscript{15}

Business groups without banks are more common in countries with legal and regulatory restrictions on groups owning banks and on banks owning non-financial firms or lending to firms that are part of the same group, as in the United States, Korea, India, Taiwan (pre-1980s), and Chile (post-1980s). Also, most governments around the world regulate foreign ownership of banks, so MNC purchases of domestic banks that once belonged to groups is usually the result of
government reforms to open up the financial sector, as was common in Latin America in the 1990s and 2000s (Martinez-Diaz 2009).

The importance of government regulation in shaping the structure of business groups is perhaps most visible in the response, usually very rapid, by business groups to changes in banking rules. For example, in the 1980s the Korean government relaxed restrictions on chaebol investment in financial firms and permitted chaebol to own limited shares in banks and controlling shares in non-bank financial firms (insurance, brokerage, etc.), and by the late 1990s the top 30 chaebol owned 76 non-bank financial firms (Chang 2003, 60–1). In Mexico, several dramatic changes in banking regulations after 1980 restructured the largest groups several times in the space of a few decades. Unrestrictive regulations prior to 1980s meant that most banks were parts of business groups and most groups had large holdings in finance (Camp 1989). Then in 1982, the government nationalized banks, and thereby stripped groups of their banking assets. By the 1990s, the government decided to re-privatize the banks, though with restrictions on foreign ownership, so that most banks ended up again in business groups (though different groups). By the late 1990s, the government relaxed restrictions on foreign ownership, MNCs bought up many banks, and by the 2000s, few Mexican groups had large banking subsidiaries.16

In sum, government policies on these three kinds of ownership -- MNCs, state enterprises, and banks (of or by other non-financial firms) -- set clear limits on the range of diversification possible and hence explain a great deal of cross national variation in group structure. Business groups may devise diversification strategies based on economies of scope or risk reduction, but they are ultimately constrained by the boundaries established by government policies. These three policy boundaries though differ in their effects over time. Banking regulations and state ownership (nationalization or privatization) can change quickly, sometimes overnight, and groups can adjust just as quickly by buying up (or relinquishing) banks and state enterprises. In contrast, MNC entry, especially in manufacturing, establishes a path dependent boundary that is subject to much less change in the short run and has a decisive long-term impact on group strategy.
IV. Business Group Responses to Liberalization and Globalization

Business groups also differed in their responses to financial shocks and market oriented reforms in the 1990s. Some groups collapsed, from Daewoo, one of the largest chaebol, to many of the major groups in Peru. Several diversified groups radically reinvented themselves as specialized firms. The sprawling Argentine conglomerate Bunge y Born underwent one of the most spectacular transformations as it sold off all but its core agribusiness interests and moved its headquarters to New York. Other groups were partially displaced by MNCs or by new kinds of leading firms (as in India (Goswami 2003)). Most groups streamlined operations, and divested at least some peripheral subsidiaries, and at the same time established new subsidiaries abroad. Not surprisingly, the comprehensive policy shifts of the 1990s had the greatest impact on policy-induced kinds of groups, and many of these went through massive restructuring. Overall though globalization has not yet, as many expected (see Schneider (2008b)), sounded the death knell for diversified groups, and market reforms in some cases opened up new opportunities for policy-induced diversification.

Privatization programs, for example, gave many business groups opportunities to grow and diversify. The story of the Mexican group Carso, the largest in Latin America, is illustrative. Carlos Slim had made a fortune on the stock market in the 1980s but then started moving out of finance and in the 1990s bought Telmex, the fixed-line telephone monopoly, when the government put it up for sale. He acquired subsidiaries in many other sectors, but made telecommunications a new core business and leveraged it into an ambitious program of international expansion. Similarly, in Argentina in the early 1990s one or more of the top 10 business groups participated in 32 of 54 firms privatized, usually in consortia with MNCs (Guillén 2001, 83). While Latin America out paced other developing regions in privatization, business groups in other regions also bought up state firms (on the Philippines, see Rivera (2003)). New capitalists in Eastern Europe and Russia of course pieced together their groups by acquiring state assets (Johnson 1997).
Other market reforms increased pressures to de-diversify. The end of many promotion policies removed the incentives for policy-induced holdings that groups subsequently divested. This process seemed especially intense in India (Ghemawat and Khanna 1998) and South Africa (Chabane, Goldstein, and Roberts 2006). Lower trade barriers and freer entry for MNCs increased competitive pressures on most groups and at the same time brought more MNC buyers looking to acquire subsidiaries. In response, many groups -- from LG in Korea, to Daimler Benz and Vivendi in Europe, to Macri in Argentina -- sold off some subsidiaries. Samsung sold off major firms to Volvo and Renault (Chang 2003, 225, 237). For the analysis of domestic groups, the most important impact of the wave of MNC entry into developing countries was to close off more major sectors of the economy, especially higher technology manufacturing and services.

However, de-diversification did not go as far as many expected nor as far as the de-conglomeration wave in the United States in the 1980s. For example, from 1985 to 1997, the top 30 chaebol increased their extent of unrelated diversification. The index of diversification dropped rapidly in the post crisis restructuring after 1997, but by 2000 the index had dropped back only to the already high levels of 1985. As one disappointed observer put it, globalization “required chaebols to narrow their business focus to a few core competencies... [but] Chaebols failed to make this transition” (Chang 2003, 78). In Taiwan, various diversification indicators for the largest 100 groups remained steady or increased after the liberalization of the 1980s and 1990s (Chung and Mahmood 2006, 80). Chile embarked on radical economic liberalization in the 1970s, well ahead of most developing countries. However, by 1988 the average range of diversification for 10 groups was 7 different sectors and the average number of subsidiaries was 9. Moreover, as free markets consolidated in the 1990s, the same 10 groups in fact increased their diversification to 8 sectors and 13 firms by 1996 (Khanna and Palepu 2000a, 275).

The most significant response to globalization by business groups, especially from developing countries, was international expansion, though the extent and type of internationalization varied significantly across regions and types of groups (see Goldstein 2007). Among developing countries, Latin American MNCs, also known as Translatins or multilatinas,
grew more slowly than MNCs from developing Asia: of the 50 non-financial MNCs from
developing countries with the most assets abroad, only seven are from Latin America (and one of
the largest of these is state owned) (ECLAC 2006, 65).

Moreover, the type or strategy of internationalization varied. Most FDI follows one of
two main logics: market seeking or efficiency seeking (ECLAC 2006; Aykut and Goldstein
2006). Market-seeking investment, usually through the acquisition of existing firms in other
countries, establishes subsidiaries abroad that produce for the host market without many linkages
to home country production. Efficiency enhancing investments often move production offshore
for export to third markets or for producing components for assembly elsewhere.

Internationalization by more organic Asian groups was predominantly efficiency seeking
(ECLAC 2006). As, rapid development and democratization in countries like Korea and Taiwan
drove wages up, business groups sought out lower wage production sites in Asia, especially
China after the 1980s.

In contrast, groups in Latin America, especially portfolio groups, relied primarily on
market seeking investment, buying competitors in foreign markets in order to secure market
share. Foreign investments by Translatins were rarely for export to third markets and almost
never for offshoring component production, in large part because most Translatins are not in
manufacturing but rather commodities and consumer services which do not offer many
opportunities for backward or forward integration. Some of the most aggressive Translatins were
more specialized firms like Cemex (cement, Mexico), Gerdau (steel, Brazil), or Falabella (retail,
Chile), while many of the more diversified firms like Votorantim in Brazil or Luksic in Chile
have fewer and smaller subsidiaries abroad. New opportunities for internationalization may in
effect offer an alternative strategy for managing risk: some firms diversify internationally by
acquiring firms abroad in their core sectors, others diversify domestically by acquiring firms at
home in different sectors. 17

These different strategies may have responded to immediate economic opportunities, but
the capacities of groups to take advantage of these opportunities derived in large measure from
the longer term evolution of business groups in the two regions and the government policies that
promoted or constrained them. That Asian business groups were guided by efficiency motives
was related to the fact that they started as export industries and grew large by exporting lower
cost (and later higher quality) goods. Translatins in contrast started much smaller because of the
limits of ISI and other policy constraints on growth, and they were less interested in offshoring
production to enhance efficiency because they had been boxed out of higher technology
manufacturing by MNCs. Moreover, the incentives for internationalizing were generally stronger
among the organic groups common in East Asia than in the portfolio groups in Latin America.

V. Conclusions and Further Questions

The primary theoretical goal, to recapitulate, was to analyze the impact of policies and
state actions on major dimensions of variation across business groups, especially in developing
countries. Business groups vary greatly in terms of size, range of diversification, and response to
globalization, and in most instances these differences can be traced back to state actions that
range from direct and deliberate (as in prohibiting the entry of MNCs) to indirect and unintended
(as in ISI). In addition to state actions, economies of scope and risk reduction provided further
insight into varying strategies of diversification, especially in the contrasting ideal types of
organic and portfolio groups.

Looking back historically to the sources of variation in economies of scope and especially
risk also usually leads back to prior state actions and policies. The promotion by the Korean
state, for instance, of domestic manufacturing in large firms was an integral part of the
development of economies of scope in core chaebol. Similarly, or conversely, domestic politics
in Latin America generated a lot of the macro-economic instability that encouraged portfolio
groups. Moreover, states intervened directly to promote or restrict the growth of business groups
as well as to set the terms of their interaction with banks, MNCs, and state enterprises. Lastly,
governments pursued a range of other policies from ISI to market reform and economic
integration that had deep effects on group strategy and structure. A major theoretical implication
of these multiple empirical routes to the establishment of diversified business groups would be a caution against efforts to construct a single explanation or logic for group formation and behavior. And, if historically business groups arose in different circumstances, developed distinct internal logics, and adapted to diverse government-imposed constraints, then there is little reason to expect them to respond the same way to later exogenous shocks and market opportunities.

This broad but brief comparative overview raises a number of issues for further research. For example, more nuanced analysis might be able to determine the range of diversification associated with different types of economies of scope based on technological, marketing, logistical, or other logics. Moreover, the concept of economies of scope has some play and room for evolution, and as such raises the question of whether groups may discover or develop new economies of the scope. Risk reduction seems theoretically to have a more constant impact on unrelated diversification, yet there are also opportunities to get more precision in determining the effect of volatility on diversification strategies by breaking out the country and sector sources of uncertainty. For example, groups that are highly dependent on domestic politics and business cycles, like cement, construction, and tobacco, may tend to diversify more internationally into other political jurisdictions, while groups more vulnerable to international price fluctuations, especially mining, can better balance risk by diversifying into other sectors.

That politics and state actions are primary explanatory factors naturally brings up questions of what motivates state actors to promote, inhibit, or shape diversified business groups. At first glance, the motivations considered earlier seem to have differed greatly over time and policy area. For example, efforts by Asian and Latin America governments to promote domestic business often grew out of geopolitical concerns and nationalism. These nationalist, developmentalist governments tended to the right wing of the ideological spectrum, yet, on the other end, social democratic governments, especially in Sweden, promoted large groups as part of their programs to increase wages, social welfare, and equality (Högfeldt 2004). At other times, it was immediate events such as financial crises that prompted governments of varying
partisan hues to adopt new regulations on group ownership of banks or cross shareholding, as in the great depression in the United States or the debt crisis in the early 1980s in Chile. Lastly, when they enter politics, business groups constitute some of the most powerful interest groups and rent seekers, and stories abound in nearly all countries of business groups seeking and getting generous favors from government (Morck, Wolfenzon, et al. 2005). The motives of state and political leaders merit further investigation, but suffice it for now to register that the motivations range widely across the left-right spectrum and from loftier goals of development and equality to more venal and self-serving exchanges.

The fact that the diversified group form is institutionally ‘sticky’ and resilient, even in the face of pressures of globalization, raises the possibility of path dependence and complementarities, in a ‘varieties of capitalism’ perspective (Hall, P. and Soskice, D. 2001). Outside the major liberal market economies (LMEs) and coordinated market economies (CMEs), especially in developing countries, business groups are unavoidable in a “firm’s eye view” of their political economies. Groups organize a lot of capital and labor internally in ways that distance them from the market coordination characteristic of LMEs, but at the same time the greater reliance of business groups on internal hierarchy distances business groups from the looser kinds of inter-firm coordination and negotiation characteristic of CMEs. In fact, strong inter-group rivalries can impede pragmatic coordination on smaller sectoral issues (see Amsden 1989). As noted at the outset, the informal coordination among firms within Japanese keiretsu, the basis for its group-based form of CME, is extremely rare if not unique, and is therefore not likely to be a model for the possible emergence of other cases of group based CMEs. In sum, group-dominated economies, especially developing economies with strong hierarchical business groups, do not easily fit either LME or CME models.

Whether business groups are a core feature of other ‘varieties’ is a topic for another paper, but it is worth noting in closing that hierarchical business groups are at least compatible with, and probably complementary to (though sometimes in negative ways), other features and institutions common in developing countries (Schneider 2008c). For example, shallow stock and
financial markets are often viewed as encouraging the development of business groups as substitutes for capital markets. Moreover, with limited options to diversify through the stock market, group owners have further incentives to diversify within their firms (Schneider 2008b). Once formed, groups can inhibit, at least passively, the development of local capital markets because they have less need for external finance and have better access to international sources. In addition, various sub-types of groups may exhibit distinctive complementarities with labor markets. Organic groups, for example, are more likely to invest in R&D, to hire more engineers and technical personnel, and to place higher value on long-term skilled employment. In contrast, groups that emerge from commodity production, are more likely to evolve into portfolio groups where the incentives for investing in research and development are lower, as is the demand for skilled technicians and workers and for longer term employment relations.

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1 I am grateful to the Tinker Foundation for financial support and to Juan Alcacer, Mark Fruin, Mark Granovetter, Margaret Pearson, Kathleen Thelen, and seminar participants at the Harvard Business School and University of Kyoto for feedback on earlier versions.

2 See Khanna and Yafeh (2007) for a full review. Several notable exceptions, and pioneering contributions, from political science include Johnson (1997) and Durand (1996), and more recently Fernández and Hogenboom (2007).

3 A number of recent works offer sophisticated political explanations for cross national variation in corporate ownership (Roe 2003; Gourevitch and Shinn 2005; Högfeldt 2004; La Porta, López-de-Silanes, et al. 2000), but they focus exclusively on the narrow issue of blockholding versus dispersed ownership, a dimension on which business groups vary little, from each other and from other private firms in their economies. Nearly all business groups have controlling owners, in a great majority of cases one or several families. In their broad comparative survey, La Porta et al. found few widely held firms outside of the United States and several other English speaking countries. Elsewhere “by far the dominant form of controlling ownership in the world is not that by banks and other corporations, but rather by families” (La Porta, López-de-Silanes, et al. 2000, 496). Given this lack of variation, the rest of this analysis does not devote much attention to shareholding patterns or the political theories developed to explain them.

4 Most large businesses engage in several activities, so it is hard to fix a precise threshold between specialized and diversified corporations, but it fits with common usage to define as diversified groups with significant activities in three or more sectors that do not share core technologies or markets. For US firms, Markides (1995, 41–3) defines “unrelated” conglomerates as those with more than 30 percent of sales in unrelated sectors. Unrelated sectors were defined as different 2-digit SIC (Standard Industrial Classification) codes or different 4-digit SIC codes in five especially diverse 2 digit categories. Lins and Sevaes (2002, 9) have a less restrictive definition: firms are diversified if more than ten percent of
sales come from industries outside their main product line (at the level of 2-digit SIC codes). My definition is closer to Markides’, but I discuss later the problems with using SIC codes to measure diversification. The analysis of group diversification gains from occasional comparisons with conglomerates in the United States that are often defined out of the category of business group because their subsidiaries are usually wholly owned, and pyramids are rare.

5 The hierarchical control exercised by most business groups does, however, fit better analytically with a distinct hierarchical variety of capitalism (comprised of a large MNC sector, weakly intermediated labor relations, high labor turnover, and low skills) that characterize many countries of Latin America and other developing countries. See Schneider (2008c; 2008a) for an elaboration of this hierarchical market economy.

6 The empirical material draws on some original research in Latin America but relies primarily on the secondary literature from as broad a range of countries as possible. The quality and quantity of coverage in English varies greatly from extensive research on Korea and Taiwan to single articles on less well known cases. The analysis also tries to draw on empirical studies of business groups in developed countries to dispel the notion that business groups are associated exclusively with poorer countries. I focus more attention on contrasts between Asia and Latin America in part because empirical research is more extensive and in part because the inter-regional contrasts bring into high relief some core differences among business groups.

7 In a global survey, the IDB (2001, 35, 40) found that, “the largest firms in Latin America are very small in comparison with other regions in the world. Among seven regions, Latin America comes in last in average size in terms of total assets of the countries’ 25 largest companies.” They found that the three variables that explained 85 percent of the variance were country size, size of the financial sector, and quality of infrastructure. These last two variables are greatly influenced by policy. However, the study looked only at the largest firms, not the conglomerates or groups to which they might belong, so the results are not directly comparable.

8 In a very different period and political context in Sweden, social democratic governments favored huge firms and adopted a number of policies to help them grow, including tax benefits for investment out of retained earnings and bank finance which favored the largest groups (Högfeldt 2004).

9 Reliable, comparable quantitative indicators of diversification do not exist. Most available quantitative estimates use the number of different SIC codes in which a group operates. For example, in India, the mean number of different industries (disaggregated to two-digit SIC codes) for a large sample of groups was 3.8 (Khanna and Palepu 2000b, 876). For ten groups in Chile, average diversification increased from 7 industries (2-digit SIC) in 1988 to 8 in 1996 (and the average number of firms from 9 to 13 (Khanna and Palepu 2000a, 275)). However, SIC codes are problematic for measuring unrelated diversification. A few 2-digit codes capture distinct sectors, e.g., tobacco and cigarettes (code 21), but most comprise huge and quite diverse industry segments. Transportation equipment, for example, code 37, includes motorcycles, cars, trucks, busses, ships, trains, airplanes, and guided missiles. Yet other codes are too specific and really just sub-groups of the one sector: 2-digit codes 52 through 59 are different kinds of retail operations (making Walmart and other large retailers some of the world’s most diversified conglomerates on a 2-digit scale). Researchers sometimes recode these and other sectors, but the reclassifications vary so the indices are rarely comparable across studies.

10 For discussions of other economic incentives based largely on market imperfections and transaction costs, see Leff 1978; Khanna and Palepu 1997; Khanna and Yafeh 2007. These theories are useful in many contexts for understanding business groups, but they are less
relevant to the kinds of variations considered in this section.

11 The Tata group in India had a deliberate long-term strategy for recruiting and training managers, promoting their mobility and communication across group firms, and assembling ‘star teams’ to solve problems in particular subsidiaries (Khanna and Palepu 1997, 49).

12 The emerging capitalist economies of Russia, Ukraine, and Rumania have been characterized as patrimonial overall and dominated by “parasitic financial-industrial groups” (King and Szelenyi 2005, 213). For a detailed case study of the rise of a patrimonial group in Bulgaria, the dominant Multigroup conglomerate, see Ganev (2001).

13 In one extreme example of setting parameters, Russian legislation in the 1990s stipulated that “banks could participate in only one financial-industrial group; banks could own no more than 10 percent of the stock of any company in the FIG; there could be no more than 20 firms in each FIG; there could be no more than 25,000 workers at each firm; and there could be no more than 100,000 workers overall” (Johnson 1997, 335).

14 Other government policies on foreign investment often promoted group diversification. For example, some countries (Mexico, India, Brazil) had policies that required MNCs to enter into joint ventures with local firms. Domestic firms with good connections and established track records generally got drawn into sectors as largely passive partners of MNCs (interview with Agustín Legorreta, former president of Banamex, 23 June 2004). Other policies promoted national content and forced MNCs to find local suppliers, which again drew groups into new sectors like auto parts.

15 Banks were prominent in groups in Russia (Johnson 1997; Perotti and Gelfer 2001), Chile (before the 1980s Khanna and Yafeh 2007, 342), Indonesia (Hanani 2006), Turkey (Bugra 1994), Taiwan (after the 1980s Chung and Mahmood 2006), and Thailand (Suehiro 1992).

16 Although there are clear differences between groups with banks and groups without, this distinction does not shade into overall distinctions made in the literature on corporate ownership between bank centered and market centered financial systems. For one, there are reservations about the usefulness of extending the classification outside of paradigmatic cases like Germany (La Porta, López-de-Silanes, and Shleifer 1999, 508; La Porta, López-de-Silanes, et al. 2000, 18–9). Moreover, though the data are sparse, it seems that groups are more likely to own banks than banks to own groups. Fligstein and Choo further disaggregate ownership patterns and distinguish four ideal typical models of corporate governance based on equity markets (especially the United States), bank ownership and financing (e.g., Germany), state ownership of banking systems (Korea until recently), and family ownership and financing (2005, 74–5). Most economies dominated by business groups, especially in developing countries would fall into the third and mostly fourth categories (La Porta, López-de-Silanes, et al. 1999).

17 Cemex, for instance, diversified geographically in order “to balance risk in one region with stability in another,” according to CEO Lorenzo Zambrano, who added, “we need to be in many markets to survive” (Business Week (International, online), 26 October 1998).
References


Table 1. Sales of the 10 Largest Business Groups in Selected Countries in 1995

<table>
<thead>
<tr>
<th>Country</th>
<th>Sales (percent of GDP)</th>
<th>Country</th>
<th>Sales (percent of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>11</td>
<td>India</td>
<td>6</td>
</tr>
<tr>
<td>Brazil</td>
<td>8</td>
<td>Indonesia</td>
<td>25</td>
</tr>
<tr>
<td>Colombia</td>
<td>28</td>
<td>South Korea</td>
<td>49</td>
</tr>
<tr>
<td>Mexico</td>
<td>10</td>
<td>Taiwan</td>
<td>19</td>
</tr>
<tr>
<td><strong>Average for Latin America</strong></td>
<td><strong>14</strong></td>
<td><strong>Average for Asia</strong></td>
<td><strong>25</strong></td>
</tr>
<tr>
<td><strong>Average for larger countries</strong></td>
<td><strong>12</strong></td>
<td><strong>Average for smaller countries</strong></td>
<td><strong>27</strong></td>
</tr>
</tbody>
</table>

Sources: Guillén (2001, 72). Larger countries include Brazil, Mexico, India, and Indonesia; smaller countries include Argentina, Colombia, Korea, and Taiwan.

Table 2. Three Types of Diversified Business Groups

<table>
<thead>
<tr>
<th>Core motivations</th>
<th>Organic</th>
<th>Portfolio</th>
<th>Policy induced</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope of diversification</td>
<td>economies of scope (&amp; vertical integration)</td>
<td>risk management</td>
<td>government incentives</td>
</tr>
<tr>
<td>Integration of management</td>
<td>narrower</td>
<td>broadest</td>
<td>broad</td>
</tr>
<tr>
<td>Group ties to subsidiary</td>
<td>high</td>
<td>variable</td>
<td>variable</td>
</tr>
<tr>
<td>Examples</td>
<td>longer term</td>
<td>shorter term</td>
<td>shorter term</td>
</tr>
<tr>
<td>General Electric (United States), Votorantim (Brazil), Samsung (Korea), Techint (Argentina), Formosa (Taiwan)</td>
<td>bank centered groups, Banamex (Mexico), Pritzker (United States), Camargo Correa (Brazil), Luksic (Chile), Wallenberg (Sweden)</td>
<td>Chaebol (1970s), privatization acquisitions, FIGs in Russia, Israeli defense contractors, Carso (Mexico), Suharto-linked groups (Indonesia)</td>
<td></td>
</tr>
</tbody>
</table>
Table 3. Diversification of Large Business Groups in Asia and Latin America

<table>
<thead>
<tr>
<th></th>
<th>Diversification</th>
<th>Assets in finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia</td>
<td>1.65</td>
<td>.01</td>
</tr>
<tr>
<td>Korea</td>
<td>1.7</td>
<td>--</td>
</tr>
<tr>
<td>Taiwan</td>
<td>1.6</td>
<td>.01</td>
</tr>
<tr>
<td>Southeast Asia</td>
<td>2.9</td>
<td>.47</td>
</tr>
<tr>
<td>Indonesia</td>
<td>2.1</td>
<td>.45</td>
</tr>
<tr>
<td>Philippines</td>
<td>3.1</td>
<td>.6</td>
</tr>
<tr>
<td>Thailand</td>
<td>3.5</td>
<td>.35</td>
</tr>
<tr>
<td>Latin America</td>
<td>3.07</td>
<td>.15</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.4</td>
<td>--</td>
</tr>
<tr>
<td>Chile</td>
<td>5.1</td>
<td>.24</td>
</tr>
<tr>
<td>Mexico</td>
<td>2.7</td>
<td>.05</td>
</tr>
</tbody>
</table>

Sources (Khanna and Yafeh 2007, 334).

References