

Should Business Groups Be Dismantled? The Equilibrium Costs of Efficient Internal Capital Markets.

Abstract

We analyze the relationship between conglomerates' internal capital markets and the efficiency of economy-wide capital allocation, and 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) 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 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, may 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 due to lack of finance.

Key words: capital allocation, conglomerates, investor protection, internal capital markets.