The diversified business group as an innovative organisational model for large state-enterprise reform in China and Vietnam

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Abstract: The diversified business group (DBG) is a ubiquitous institution in developing economies. It is a formal inter-firm network that typically involves financial institutions, distributors and manufacturers. Groupwise diversification is viewed by some as a novel form of organisational innovation by entrepreneurial tycoons while others see it as an instrument for rent seeking. Inspired by Korean chaebols but chastened by Russian financial-industrial groups, China and Vietnam are creating business groups out of State enterprises. After reviewing the theory and cross-country experience, this paper concludes that selective economic grouping can be an efficient transitional organisation. DBGs can facilitate government monitoring, exploitation of scale economies for scarce managerial talent, better risk management, and realisation of network and scope economies. Success in incubating national champions is, however, predicated on a high technocratic capability for restraining abuse of market power, nurturing competitive market institutions, properly sequencing large-scale privatisation, and crafting WTO-compatible industrial and technology policies.

Keywords: diversified business group; organisational innovation; late-industrialisation; state enterprises; China; Vietnam.


Biographical notes: Berhanu Abegaz is Professor of economics at The College of William and Mary. His research interests are wide-ranging and focus on developing economies and transition economies. He is currently researching organisational innovations and policy frameworks that would speed up technological diffusion in the fledgling industrial sectors of Sub-Saharan Africa.

1 Introduction

Much like their counterparts in the history of the developed countries, industrial entrepreneurs in late industrialising economies and their technocratic allies have responded in myriad ways to the dearth of knowledge-based assets at their disposal
(Amsden, 2001). An intriguing strategy for telescoping the large technological gap with leaders has taken the form of organisational adaptation. Three variants are worth noting. The first, taken to an extreme point by the formerly socialist countries, is preference for large-scale firms to take advantage of scale economies (Schumpeter, 1934; Gerschenkron, 1962; Chandler, 1990). The second, a much less understood and appreciated response, is group-wise diversification especially into unrelated activities. The central goal in this case is exploiting scope and learning economies, or overcoming market-based coordination failure (Strachan, 1976; Leff, 1978; Goto and Akira, 1982; Granovetter, 1994). The third, a recent development, is network-wise specialisation by suppliers seeking profitable nodes and technology-upgrading opportunities in global value chains (Mathews, 2002; UNIDO, 2002). Diversified Business Groups (DBGs) have two key characteristics: they are diversified across distinct markets, and they include a large number of member firms in a formal group. The most salient features of group networks involve a group governance system undergirded by varying and ever-changing mixes of director interlocks, mutual equity ownership, debt relationships, trade relationships, personnel exchanges, political ties with state actors, and social ties among key players. Economic grouping is a prominent feature, especially of the industrial landscape of late industrialising countries. DBGs, whether market-induced or State-orchestrated, have a prominent presence in the industrial and business-service sectors especially in the larger economies of Latin America, Asia and post-socialist Russia.

The DBG does not have a standard definition. Common usage excludes such business relationships as temporary and strategic inter-firm alliances, location in informal industrial districts, independent multi-divisional firms, or most conglomerates and holding companies with single ownership (see Leff, 1978; Granovetter, 1994). It will be defined here as an enduring network that satisfies four conditions:

- each affiliate is a legally independent entity (diversity of membership)
- affiliates are represented in a variety of industries or markets (diversity of assets)
- affiliates are bound together by a medley of business, shareholding and social ties (networking)
- affiliates cede authority to a core manufacturer or a bank (controlling industrialist or financier).

The regional patterns of group organisation that more or less satisfy this definition include Korea’s chaebol (jae-hul), Japan’s prewar zaibatsu and postwar keiretsu, Italy’s tightly knit industrial-district groups, China’s qiye jituan, some of Taiwan’s guanxi qiye, Russia’s financial-industrial groups or FIGs (semibankirshchina), India’s large business houses, Indonesia’s konglomerat, and Latin America’s grupos economicos. Despite the diversity of the contexts in which economic groups exist, we argue below that there is sufficient similarity among DBGs across regions for comparisons to be validly made.

Why do DBGs exist at all? While the nature of State-group relations vary across regions, groupwise diversification and developmentalist states are viewed by many as effective strategic responses, planned or evolutionary, to the conditions faced by late developers.
The diversified business group as an innovative organisational model

The prevalence of weak domestic markets and the need to build up local capability for technological learning offered by uneven global development means that the propensity for grouping can be explained as an effective vehicle for catching up. Economic grouping is value-adding insofar as it helps associated firms to exploit resource specificity and to substitute for missing markets or for poor contract enforcement. Long-term relationships and cross-holding among assemblers, input suppliers, credit providers, distributors, and investors generate a dense enough internal market (especially for capital and managerial skills) that can be shared across affiliates. This institutional innovation provides a stepping stone to organisational forms (such as traditional conglomerate or arm’s-length market contracting among stand-alone firms) that are generally more efficient when extensive markets are in place (Leff, 1978).

Groups can also have a dark side arising mainly from agency problems. The most notable liabilities, a favourite of the corporate finance literature, involves rent seeking, including tunnelling of returns away from minority shareholders. Again, as budding industries mature and the sources of long-term financing are diversified, market forces disfavour formal economic groups, giving way to looser business alliances. The advantages of competition eventually outweigh those of cooperation.

This paper critically examines these issues by focusing on two interrelated questions regarding organisational innovation in developing countries. Has groupwise diversification been an effective mechanism for enhancing the productivity and competitiveness of fledgling enterprises in the incentive environment of late-industrialising market economies? If so, could a suitable version of it serve as a template for reorganising large State enterprises in the Asian transition economies, at least until the appropriate market infrastructure and the political will are mustered for undertaking large-scale privatisation?

Drawing on the literature at the intersection of development economics, industrial organisation, corporate finance and post-socialist transition, we aim to contribute to this debate in three ways. Firstly, we offer an analytical framework for thinking about the multi-faceted task of assessing the competitive advantage of network synergy over corporate focus. This will be done in a Schumpeterian spirit by relating groupwise diversification to the domestic and external environments that have shaped firm behaviour in the emerging economies. Secondly, we review the recently available econometric evidence as well as country case studies on the impact of group affiliation on firm performance. Thirdly, in the light of the preference for hybrid institutions in the Asian post-socialist transition, we tease out the implications for second-generation State enterprise reform in China and Vietnam.

We conclude that, while business groups tend to be rent seeking in the extreme cases where markets are either poorly developed or well established, they are on the whole paragons in those middle-income economies whose fledgling industrial systems badly need patient capital and flexible organisation in order to reach the threshold of global competitiveness. Given the political unpalatability of, and arguably large welfare losses associated with, large-scale privatisation (i.e., on account of the absence of the requisite market and regulatory institutions), China and Vietnam might very well find well-regulated business groups an attractive transitional model for cultivating dynamically efficient networks that cut across ownership forms. Such networks can, under a good policy framework, help promising firms in the two countries to economise on scarce managerial skills and high transaction costs, ease risk management by providing a mechanism for mutual insurance, and accelerate technological diffusion.
The discussion proceeds as follows. The evolution and economic performance of business groups in developing economies is briefly reviewed in Section 2. The most distinctive features of business groups in the East and Southeast Asian market economies are outlined in Section 3. Emerging business groups in post-socialist Russia are examined in Section 4 as counterexamples, while nascent group formation in China and Vietnam is reviewed in Section 5. The lessons for large-scale State-enterprise reforms are distilled in Section 6, and recapitulated in the concluding section.

2 Theory: the phenomenon of groupwise diversification

That groupwise diversification has historically been pervasive in successful late industrialisers does not necessarily imply that such an organisational form is necessary for the industrialisation of latecomers. Its ubiquity, however, suggests that there is something structural about the phenomenon that calls for an explanation. The appropriateness of particular forms of enterprise organisation and firm behaviour must, therefore, be viewed in the context of the institutional and incentive environment that prevails at the various stages in the evolution of markets.

2.1 The evolution of DBGs

There are two interrelated theoretical issues that lurk behind the debate on the significance of DBGs. The first pertains to the very existence of firms; stand-alone or networked. Neoclassical theories, institutional or organisational, posit well-functioning markets as ultimate causes of economic development and accordingly rationalise the existence of large business organisations in terms of imperfections or even failures of markets (Williamson, 1985; North, 1990). Critics argue for reversing the direction of causality. It is organisations (firms, governments), rather than markets, that play the lead role in allocating resources and introducing innovations (product and process) to spearhead both market deepening and economic development (Schumpeter, 1934; Lazonick, 1991).

The second issue has to do with the relationship between the structure of business organisation and firm strategy. The orthodox view is Chandlerian. That is, organisational structure follows strategy. In a world of dispersed ownership, competitive advantage originates in the firm’s capability for endogenous organisational innovation. This is attributed to strategies, such as large-scale production, flexible specialisation, or diversified product lines that reflect the external conditions faced by the firm including those related to factor supplies, domestic and international demand, supporting services, and infrastructure (Chandler, 1990).

The innovativeness of enterprise organisation and behaviour is related, in a stylised form, in Table 1 to the ‘selection environments’ of emerging economies. If one assumes reasonably that the learning process is collective, cumulative and uncertain, then rational entrepreneurs respond to, or seek to shape, the institutional and policy environment. This process would involve a coevolution of market and non-market allocation mechanisms (Schumpeter, 1934; Nelson and Winter, 1982; Aoki, 1990; Lazonick, 1991).
Table 1  Stylised selection environments and corporate structures of latecomers

<table>
<thead>
<tr>
<th>Feature</th>
<th>Emerging market economies</th>
<th>Emerging transition economies</th>
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<tbody>
<tr>
<td><strong>Selection environment</strong></td>
<td></td>
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<tr>
<td>Factor markets</td>
<td>Bank-centered financial markets</td>
<td>State bank-dominated markets</td>
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<td></td>
<td>Unreliable input suppliers</td>
<td>Seller’s market or shortage economy</td>
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<td></td>
<td>Good formal property rights regime</td>
<td>Ambiguous property rights regime</td>
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<td></td>
<td>Fair to good supply of high skills</td>
<td>Good (Europe) to fair (Asia)</td>
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<tr>
<td>Product markets</td>
<td>Inadequate distribution system</td>
<td>Poor distribution system</td>
</tr>
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<td></td>
<td>Competition from imports and SMEs</td>
<td>Limited but strong as in China</td>
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<td></td>
<td>State procurement is important</td>
<td>State procurement is paramount</td>
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<tr>
<td>Infrastructure</td>
<td>Uneven quality of utilities, transportation and communication</td>
<td>Outdated utilities, transportation and communication</td>
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<td></td>
<td>Public sector is important supplier</td>
<td>Public sector is primary supplier</td>
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<td>Industrial policy</td>
<td>State-business reciprocity</td>
<td>State capture or partnership</td>
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<tr>
<td></td>
<td>Strategic or functional</td>
<td>Haphazardly selective</td>
</tr>
<tr>
<td></td>
<td>Emerging regulatory framework</td>
<td>High formal to non-existent</td>
</tr>
<tr>
<td></td>
<td>Development banks are important</td>
<td>Quasi-development banks</td>
</tr>
<tr>
<td></td>
<td>From result to rule orientation</td>
<td>Lingering commandism and gigantism</td>
</tr>
<tr>
<td>Global</td>
<td>Globally integrated value chains</td>
<td>Globally integrated value chains</td>
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<td></td>
<td>Soft-hearted GATT rules</td>
<td>Hard-headed WTO rules</td>
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<td></td>
<td>Access to FDI and portfolio</td>
<td>Access to export-oriented FDI</td>
</tr>
<tr>
<td>Organisation and behaviour of firms</td>
<td></td>
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<tr>
<td>core capability</td>
<td>Managerial and technical capability in industry</td>
<td>Retire connections plus technical skills</td>
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<tr>
<td></td>
<td>Domestic firm-led or MNC-led</td>
<td>Domestic firm-led: state sector</td>
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<td></td>
<td>Learning: process-oriented</td>
<td>Learning: process and product</td>
</tr>
<tr>
<td>Firm’s strategy</td>
<td>Debt-financed growth</td>
<td>Bank-financed and state-captive</td>
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<td>Knowledge acquisition and spillovers</td>
<td>Knowledge acquisition and spillovers</td>
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<td></td>
<td>Market share then profitability</td>
<td>Market share then profitability</td>
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<td></td>
<td>Transaction cost then agency cost</td>
<td>Agency cost then transaction cost</td>
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</tbody>
</table>
### Table 1  Stylised selection environments and corporate structures of latecomers (continued)

<table>
<thead>
<tr>
<th>Feature</th>
<th>Emerging market economies</th>
<th>Emerging transition economies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group network</td>
<td>Moderately-related diversification</td>
<td>Related and unrelated, including cash cows</td>
</tr>
<tr>
<td></td>
<td>Pyramids and family control</td>
<td>Highly concentrated: state or family</td>
</tr>
<tr>
<td></td>
<td>Internal capital and managerial markets</td>
<td>Controlling firm as central planner</td>
</tr>
<tr>
<td></td>
<td>Managing economic and political risk</td>
<td>Managing economic and political risk</td>
</tr>
<tr>
<td></td>
<td>Varying forms of coordination, but favour greater focus</td>
<td>From centralisation to disorganisation and then to reorganisation</td>
</tr>
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</table>

**Sources:** Various.

A sequential conceptualisation of the evolution of business organisation is also depicted schematically in Figure 1. For comparative purposes, three possible models of DBG can be identified in terms of the tightness of the network: a *keiretsu*-type confederal model of loose affiliation, a *grupos*-type federal model of close affiliation (with minority co-ownership), and a *chaebol*-type quasi-unitary model of tight grouping (with majority ownership of stocks in member firms by the core firm).

**Figure 1** Paths of business diversification and control in the course of industrialisation

Company histories strongly suggest that modern DBGs evolved out of Family Business Groups (FBGs) that were established by resourceful business tycoons who, more by trial and error than by grandiose plan, diversified their asset portfolios in response to the
absence of efficiently functioning markets. State support or discrimination (as in the case of Chinese minorities in Southeast Asia) was an important feature of group formation in Asia and elsewhere (Carney and Gedajlovic, 2003; Kim et al., 2004).

In the earliest stage of industrialisation, markets are poorly developed on both the supply side and the demand side of the equation. Generic features of underdeveloped markets include lack of access to a highly skilled workforce, repressive labour relations, low domestic demand due to low per capita incomes, limited access to modern technology, insufficient industrial management experience, unstable macroeconomic conditions, poor infrastructure, particularly for transportation and communication, and inadequate sources of long-term bank as well as venture capital. Furthermore, the political environment is typically pervaded by authoritarian, parasitic and personal rule.

An important asset of ambitious entrepreneurs at this early stage is ‘connection’ which often permits the full play of extremely scarce organisational or technical skills. The fusion of wealth and political power in such a capricious environment leads to a strong preference by firms for capturing pure rent, or short-term cash flows over long-term profitability. In other words, the prevailing selection environment, which is characterised by high risk, low trust and high social embeddedness of business activity, favours those firms that are engaged in related as well as in unrelated diversification under tight family control. This process has historically produced mercantile business empires, trading houses, and import-substituting firms operating in a wide array of (initially) protected domestic markets (Strachan, 1976; Leff, 1978; Jones and Wale, 1998).

Under more propitious environments (such as those that combine government support with reciprocity), however, entrepreneurs enjoy adequate expected returns to engage in the risky task of building up domestic industrial capacity. This puts a high premium on technological diffusion and incubation of new firms to fill missing links in domestic value chains (Garrido and Peres, 1998; UNIDO, 2002; Carney and Gedajlovic, 2003).

Long gestation lags are also involved in training skilled workers, in identifying secure markets, and in building up networks of finance and distribution. Even where local firms are well established, the self-limiting nature of import substitution and family management (and inheritance customs that may lead to inefficient fragmentation) frustrates the transition into professionally-managed and outward-oriented industrial corporations (Leff, 1978; World Bank, 1993; Garrido and Peres, 1998; Kock and Guillen, 2001).

The discernible patterns of group formation and growth, in fact, suggest an inverted-U relationship between the index of groupwise diversification and the level of industrial development. In this stylised, three-stage conceptualisation of the history of industrial deepening, the more flexible networks of family enterprises give rise to modern DBGs which, in turn, yield to publicly-traded multidivisional corporations or holding companies. In the last stage, as the Japanese and Korean experiences clearly shows, tight grouping becomes more of a liability than an asset. Loose alliances among firms and arms-length relationships between business groups and the State bureaucracy eventually become the new norm (Aoki, 1990; Yafeh, 2002).

2.2 A parasite-to-paragon hypothesis

A hypothesis concerning the economic significance of business groups in the course of economic development, therefore suggests itself. That is:
Business groups tend to be rent seeking ‘parasites’ in the early and late stages of industrialisation, while they are on the whole innovative ‘paragons’ in the intermediate stage.

This hypothesis, in fact, suggests a reconciliation of two apparently conflicting but stage-specific claims. The positive view argues for viewing, at least post hoc, the diversified business group as an effective endogenous response to the structural constraints of weakly-developed domestic markets and uneven global industrial development (Goto, 1982). A growing number of studies of business organisation in latecomers (see, for example, Amsden, 2001; Kock and Guillen, 2001) strongly suggest that the propensity to engage in groupwise diversification under a strategic controller reflects a rational response by innovative entrepreneurs to pervasive market failures, and to what may be called the ‘disadvantages of backwardness’ with regard to industrial capabilities (management, finance, marketing and technological knowledge).

The negative view accentuates the dark side of grouping as an organisational mechanism for unproductive activities. Socially and politically well-connected tycoons expend scarce resources on unproductive rent-creating and rent-dissipating activities. These redistributive efforts are directed especially at exploiting social and political connections to obtain exclusive licenses and subsidies, or to over-exploit first-mover advantages for introducing new industries. In modern settings, groups are also used as instruments for the expropriation of minority investors.

While it is difficult to offer a definitive test in the absence of a robust theory and counterfactuals, it is possible to offer highly suggestive evidence for or against the hypothesis. In this regard, a number of econometric studies that analyse cross-sectional data on DBGs have appeared in the past few years.

Gauging the net economic effects of economic groups econometrically is, as Khanna (2000) rightly points out, fraught with problems. First, most studies are limited to publicly traded firms although the bulk of groups in emerging markets are unlisted. Second, reverse causality, arising from possible endogeneity, is a potential problem. The latter problem is, however, mitigated by the fact that the core firm in the group generally controls the admission of new members or the creation of new firms.

The readily available cross-country evidence does paint a somewhat mixed picture. Some studies show that dominant members of DBGs engage in tunnelling (see Bertrand et al., 2002; Bae et al., 2002). It is not, however, clear why minority shareholders would knowingly tolerate this expropriation unless countervailing benefits are derived from group affiliation.

Other studies suggest that DBGs in emerging markets are value adding. It shows up in the form higher profitability or higher productivity (Khanna and Rivkin, 1999; Keister, 1998; Perotti and Gelfer, 2001). Studies based on rates of asset returns and Tobin’s q also show that firms that belong to DBGs in emerging economies perform much better than non-affiliated firms.

For the developed countries, the available econometric evidence shows that groups have lower rates of return than non-affiliated firms. Headquarters of groups and conglomerates are sometimes accused of practicing a kind of ‘socialism’ by under-investing in divisions with relatively good prospects. The stock markets react unfavourably to such unwarranted decreases in corporate focus and fear of expropriation of minority owners by imposing an over-diversification discount (Claessens et al., 2000; Khanna, 2000).
Further insight into the political economy of grouping can be gleaned from the experience of East Asia and Russia with such groups. We take them up next since the nuanced case studies also offer instructive, albeit sobering, lessons for Chinese and Vietnamese policymakers.

3 Business groups in East Asian market economies

Industrial companies in capitalist East Asia are typically bank-led or family-held entities (Claessens et al., 1998; 1999; 2000). They display a strong investment drive, orientation toward increasing market share, varying degrees of price-making power in domestic markets, and a paternalistic relationship between employer and employee. The culture of companyism and labour repression, at least until very recently, is complemented by government paternalism toward large business (Amsden, 2001; Lall, 1997).

Leaving aside the special case of Japan, the emerging East Asian market economies boast a high level of group affiliation, most notably among industrial firms. Business groups are prominent in Indonesia, South Korea, the Philippines, Malaysia, Thailand, and even Hong Kong. Average asset size for multi-segment groups exceeded half a billion US dollars in the mid-1990s in all but the Philippines. They are much less important in Taiwan and Singapore, though State-led groups are prominent players in the latter (Wade, 1990; Chung, 2003).

The role of the Korean government, as guarantor and taskmaster, is particularly instructive. It provides credit-subsidy and guarantees for hard-to-get foreign loans to the chaebols. What makes this support novel is that it is conditioned on the family-owned conglomerates committing a significant amount of own resources to investment, moving into capital and skill intensive industries, and expeditiously attaining competitiveness in export markets (Amsden, 1989; World Bank, 1993; Choi and Cowing, 2002). A central feature of Korea’s industrial landscape is the prominence of highly leveraged and vertically integrated business groups. They are major players, even after the 1997 financial crisis exposed the weakness of unrestrained diversification and led to the demise or significant streamlining of many groups (Kim et al., 2004). They still remain prominent in heavy and chemical industries accounting for 25–66% of value added. In the mid-1980s, the top 50 Korean business groups accounted for one-fifth of GDP.¹

The significance of large diversified firms in the industrial and tertiary sectors of East Asian economies can be gleaned from the data analysed by Claessens et al. (1998, 1999, 2000). Nearly two-thirds of some 13,000 publicly listed firms in East Asian market economies have multi-industry presence even at the broad two-digit ISIC level. Interestingly, firm-level diversification by affiliates is a complement rather than a substitute for group-level diversification.

Claessens et al. (1998, 1999, 2000), using data from nine middle-income countries on listed companies affiliated with corporate groups, also uncover interesting patterns. First, group-affiliated firms, most of which are controlled by financial institutions, have lower accounting profitability, higher leverage, and larger size than independent firms do. This reflects their propensity for high investment rates and the resulting debt/equity ratios that are over twice those of Europe or North America. Second, industrial houses in the more developed East Asian countries benefit from diversification (i.e., learn faster) more than their counterparts in the less developed countries of the region.
Third, coupling firm-level diversification with group affiliation, far from being overkill, can be an effective way of creating efficiency-enhancing internal markets. Groupwise diversification appears to circumvent high market-contracting costs. Lastly, some dominant stockholders use their control over groups as a means of expropriating minority holders. In another study (Claessens et al., 2002), the authors show that mature and slow-growing firms financially benefit more from affiliation than young and high-growth firms.

4 Business groups in post-socialist Russia

As noted above, government support for DBGs followed their genesis in the private sector. By contrast, DBGs in post-socialist economies were creations of the State under schemes involving varying degrees and forms of privatisation.

Transition economies, needless to say, are confronted by twin development challenges. As middle-income countries, they face the challenge of technologically upgrading their economies and integrating themselves with the world economy along sensible lines. Furthermore, as post-socialist economies, they need to restructure or mobilise their considerable industrial and human resource bases to generate broadly shared economic growth. Organisational innovation, therefore, plays a key role in technological upgrading as in the case of other developing economies.

It would also be useful to note here that the classical socialist enterprise operated in a selection environment characterised by pervasive shortage (see Table 1). That was why it was biased toward output maximisation (but against innovation), input hoarding, hyper-vertical integration to deal with unreliable supply chains, provision of a wide array of social services to its employees, and accumulation of political capital (Kornai, 1992; EBRD, 2001; Aslund, 2002). On the positive side, the socialist legacies include such growth-friendly attributes as a rich base of human capital, substantial industrial experience, and low inequality in the distribution of wealth (Easterly, 2001).

The collapse of central planning inevitably paved the way for the emergence of extensive market relations. Long-established economic linkages were dissolved along with the destruction of an unprecedented amount of economic information. Longstanding relationships between suppliers and users became untenable in the twilight zone between plan and market. Large State enterprises beset by huge bad debts and a redundant workforce, followed various defensive strategies to cope with what has come to be called transformational depression (see Blanchard, 1997; Megginson and Netter, 2001).

The twin strategies of lobbying for more State support and exploring new market linkages met with varying degrees of success depending on initial conditions and policies. In a world of weak regulation and decentralised administrative guidance, alliances with local authorities and industrial-ministry patrons remained important. This proved useful for a while in protecting regional markets, improving leverage over organised workers, ensuring maintenance of public infrastructure, and securing access to State financial institutions. A growing number of companies, especially in countries with gradualist reform programs, formed powerful industry associations and loose alliances, often at the instigation of overburdened regional governments (Blanchard, 1997; Qian, 2000; Recanatini and Ryterman, 2000).
It is in this less than auspicious environment that grouping emerged as an appealing form of strategic (i.e., defensive) reorganisation for partially or fully privatised firms in Russia. The most powerful groupings took the form of financial-industrial groups under the control of a handful of politically astute young oligarchs – men who successfully sought to convert power into private wealth.

FIGs are defined in Russian Law simply as “a group of enterprises, institutions, organisations, lending and financial institutions and investment institutions officially registered at the federal level” (Johnson, 1997, p.334). The growth of economic groups parallels the three waves of privatisation in Russia during 1992–1999: mass (voucher) privatisation, loans-for-share swaps, and case-by-case-privatisation. The morphing of the financial entities as leaders of FIGs was more or less completed as the new cadre of oligarchs successfully pushed Boris Yeltsin into a hard-fought second term. Unprecedented rewards soon came in the form of loan-for-equity swaps. The banks owned by the oligarchs, using mostly the government’s own funds deposited with them, advanced large loans to the cash-strapped federal government (Aslund, 2002; Hoffman, 2002).

Following the election, the private banks were permitted to encash the high-yield government bonds and to redeem the blocs of State-enterprise shares they had held as collateral in strategic industrial and extractive sectors. The captains of finance understandably proceeded to acquire a foothold in industry by purchasing the shares themselves at fire-sale prices in blatantly rigged auctions.

By 1997, there were 36 registered (bank-led as well as industry-led) groups comprising over 500 enterprises and 70 banks, which together accounted for nearly one-third of Russia’s GDP. In 2002, just eight business groups control 85% of revenue from Russia’s 64 biggest private companies (Travernise, 2002). The big eight financial-industrial giants (by ultimate owner) were: Logovaz (Berezovsky), Menatep (Khodorokovsky), SBS-Agro (Smolensky), Alfa Bank (Fridman-Aven), Mikrodin (Yefanov), Gazprom (Cheronomyrdin-Vyakhirev), Inkombank (Vinogradov), and Uneximbank (Potanin).

Overall, the performance of Russia’s bank-led groups has been less than stellar. Perotti and Gelfer (2001), using a broader definition of groups that includes sector-oriented conglomerates, arrive at two conclusions:

- bank-led groups benefit from a more efficient allocation of investable funds than the loosely organised industry-led groups
- investment is equally insensitive to internal finance as between members of industry-affiliated firms and unaffiliated firms.

A notable inference is that core banks contributed to group success by acting as a central planning board for coordinating key investment decisions. Core manufacturers, on the other hand, provided leadership for such purposes as marketing and political influence.

It would be useful to note here that two important developments have taken place under V. Putin, who once promised to liquidate the oligarchs as a class. (Lloyd, 2000; Travernise, 2002). The first is that, in a climate of semi-legality, the large business groups continue their strategy of buying up entire industries and consolidating their far-flung holdings. Currently, the most prominent tycoons include O. Deripaska, R. Abramovich, M. Fridman, M. Khodorkovsky, V. Potanin, V. Ackperov, V. Kadannikov, V. Bogdanov and V. Yevtushenko.
strategy of kleptocratic accumulation by corrupting the political system as king-makers. The few who insist on aggressively seeking to be big players in both the political and economic spheres appear to have been outmanoeuvred by the Kremlin. The most prominent examples are Berezovsky (exiled) and Khodorkovsky (under detention on charges of massive tax evasion, with his Yukos oil giant auctioned off and likely to be absorbed by Gazprom).

5 Group formation in China and Vietnam

In the light of the weaknesses of the legal system and significant State ownership of assets even in privatised enterprises, economic groups in China and Vietnam do not strictly meet all four criteria that we used to define DBGs. The potential for corruption and regulatory capture is, therefore, potentially high so long as the State remains both regulator and significant shareholder.

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<tr>
<th>Item</th>
<th>China</th>
<th>Vietnam</th>
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<tr>
<td><strong>Overview</strong></td>
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</tr>
<tr>
<td>The New Constitution</td>
<td>Equality of private and public</td>
<td>Equality of both</td>
</tr>
<tr>
<td>Output Share</td>
<td>25% of IVA</td>
<td>45% of IVA</td>
</tr>
<tr>
<td>Large SOEs</td>
<td>70% of assets and IVA</td>
<td>60% of assets and credit</td>
</tr>
<tr>
<td>Reserved areas</td>
<td>Utilities, military, infrastructure, capital intensive, key services</td>
<td>Negative list, People’s Committee can veto any item</td>
</tr>
<tr>
<td><strong>Second-generation reforms</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Focus</td>
<td>Governance of large SOEs</td>
<td>Small SOE privatisation</td>
</tr>
<tr>
<td>Budget constraint</td>
<td>Hardened for most SOEs</td>
<td>Hardened for few</td>
</tr>
<tr>
<td>Social welfare</td>
<td>Transferred to government</td>
<td>SOE did not provide much</td>
</tr>
<tr>
<td>SOE management</td>
<td>Large SOEs corporatised; managerial autonomy</td>
<td>Limited equitisation so far; non-financial autonomy</td>
</tr>
<tr>
<td>Ownership</td>
<td>Equity sale by large SOEs</td>
<td>Limited sale of equity</td>
</tr>
<tr>
<td></td>
<td>120 SOEs to form holding cos</td>
<td>GCs for strategic SOEs</td>
</tr>
<tr>
<td>Non-state Sector</td>
<td>Level playing field for most</td>
<td>SOEs are still privileged</td>
</tr>
<tr>
<td>FDI joint ventures</td>
<td>JVs are competitive: exports</td>
<td>JVs are non-competitive</td>
</tr>
<tr>
<td>Commitments</td>
<td>Accession to WTO in 2001</td>
<td>Regional and bilateral</td>
</tr>
<tr>
<td><strong>Group formation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Timing</td>
<td>Since late 1980s</td>
<td>Since mid-1990s</td>
</tr>
<tr>
<td>Initiative</td>
<td>Regional guvs. and bureaus</td>
<td>State-led conglomerates</td>
</tr>
<tr>
<td>Types</td>
<td>Small and large groups</td>
<td>To be led by large SOEs</td>
</tr>
</tbody>
</table>

IVA = industrial value added; PE = private enterprise; SOE = state-owned enterprise; GC = general corporation.

Furthermore, the SOE sector in Vietnam and China remains highly concentrated and omnipresent. In Vietnam, it accounts for one-third of government revenues, half of export proceeds and outstanding domestic bank credit, one-fifth of total investment, and one-sixth of non-agricultural employment. The 200 largest Vietnamese SOEs claim some 60% of state capital, 40% of total debt and most of the operating profit.

The biggest Chinese SOEs, quite large in terms of employment by international standards, contribute over two-thirds of industrial value added. The biggest 500 private enterprises in China, by comparison, report barely two percent of the sales revenue generated by State enterprises (World Bank, 2000; 2002; IMF, 2003). The current status of ownership and governance structures of large, strategic SOEs in China and Vietnam is shown in a condensed form in Table 2.

5.1 China’s jituan

Inspired by the unprecedented technological achievements of the Korean chaebol, the Chinese began to experiment with group formation in the second half of the 1980s, which resulted in the establishment of some 50 groups by 1990. Initially, grouping took the form of industry-wide mergers and acquisitions involving downstream and upstream enterprises that belong to various industrial bureaus (Keister, 2000).

This process of unbundling of large State monopolies and rejigging them into groups accelerated in the 1990s especially after the Fifteenth Party Congress in 1997. The first track of China’s dual-track approach to economic reform focused on privatisation (including constitutionally guaranteed equal treatment for private property and State property). It took the form of outright sale and shareholding schemes for small and medium-size enterprises. Non-state enterprises, which recorded strong productivity growth, account for more than half of industrial output and two-thirds of the enterprises (Jefferson et al., 2000).

The second track aims at converting 500–1000 large SOEs into holding companies or business groups (qiye jituan). Many employ a pyramiding structure, thereby giving the State (as the lead principal) more control rights than is warranted by its income rights (Watanabe, 2002). Core firms applying for registration are required to provide a strong economic rationale for grouping and a clear plan to deal with the concomitant shedding of excess labour. While many of the hundreds of groups are led by medium-sized, regional players, a few are led by nascent national champions (Nolan, 2002).  

Keister (1998, 2000) provides a good glimpse of the structure and conduct of Chinese groups. Her findings, based on two rounds of sample surveys of 40 of the largest jituan in 1990 and again in 1998, suggest that well-regulated groups hold high promise:

- The attraction of groups for potential affiliates is described by managers as an application of the bigger-is-better principle. Belonging to a group is perceived as advantageous in terms of scale economies in production, distribution and management of technology, greater political influence, greater access to finance, a more stable supply of key inputs and markets for output, higher status and prestige (especially brand name recognition), and higher trust rooted in strong social, regional and administrative ties developed under central planning.
In terms of the structure of authority, the large jituan resemble the Japanese ‘industrial’ kereitsu in that the core firm made key decisions on behalf of the group. Other areas of resemblance include interlocking directorates, financial linkages, commercial ties and manager rotations.

The exchange of board members, commercial goods and managers within groups was reciprocal while the exchange of capital was largely from the more secure core firm or finance company to affiliates with limited extra-group options.

Controlling for other determinants of financial performance, firms belonging to densely connected groups performed better financially than those in loosely connected groups. Denser inter-firm connections within groups were also positively correlated with higher financial performance and productivity performance. Furthermore, firms in groups with interlocking directorates, finance companies, and research and development companies performed better than those belonging to groups without these features.

5.2 Vietnam’s general corporation

In Vietnam, corporatisation and equitisation (i.e., partial privatisation) are in their early stages of development (Fforde and de Vylder, 1996; Lavigne, 2000). Despite slow but steady liberalisation of trade and investment codes, the State still intends to control the commanding heights as the sole or the controlling owner. The distribution of industrial output is currently 42% in the state sector proper, 22% in the non-state collective sector, and 36% in the foreign-invested sector. FDI in resource- and labour-intensive manufacturing is likely to remain important, since oil, textiles and footwear account for half of exports (IMF, 2003).

Vietnam’s largest 200 SOEs, much like China’s largest 500 SOEs, are on the whole financially (but not necessarily economically) profitable. They contribute a substantial portion of the revenue collected by the Treasury. Large SOEs absorb a lion’s share of State-bank credit, and their average debt-to-equity ratios and productivity are far better than those of medium-scale public enterprises. The average size of even the top 100 Vietnamese SOEs is, however, rather small, reflecting a history of small-scale industrialisation (see Table 3).³

Group formation in Vietnam is in its infancy, and the inspiration seems to come from China and South Korea. The leadership’s intention to establish conglomerates can be inferred from the 1995 (and 2001) Vietnamese Law on Enterprises. The Law permitted, following the Chinese example, the establishment of conglomerates (if not full-fledged groups) known as General Corporations (GC).

A bona fide GC is envisaged to satisfy three expectations, namely, that it be involved more than one industry; have a particular orientation or core competence that justifies the links among disparate firms; and establish own finance company to mobilise and allocate capital for the group. Eighteen GCs have been established so far with the following sectoral orientation: five in public utilities and business services, four in mining and agriculture, and nine in manufacturing. Sub-sectors of manufacturing without GCs include skill-intensive branches such as machinery, and labour-intensive branches such as fabricated metals, wood, furniture and non-metallic products.
The diversified business group as an innovative organisational model

Table 3  Vietnam: plans for State enterprise restructuring, 2000–2002

<table>
<thead>
<tr>
<th>By capital</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>More than ten billion VND$^a$</td>
<td>54</td>
<td>68</td>
<td>94</td>
<td>216</td>
</tr>
<tr>
<td>1–10 billion VND</td>
<td>452</td>
<td>415</td>
<td>366</td>
<td>1,233</td>
</tr>
<tr>
<td>Less than one billion VND</td>
<td>292</td>
<td>250</td>
<td>289</td>
<td>831</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>By policy measure</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Merger</td>
<td>179</td>
<td>107</td>
<td>94</td>
<td>380</td>
</tr>
<tr>
<td>Divestiture$^b$</td>
<td>508</td>
<td>481</td>
<td>500</td>
<td>1,489</td>
</tr>
<tr>
<td>Liquidation and bankruptcy</td>
<td>95</td>
<td>132</td>
<td>141</td>
<td>368</td>
</tr>
<tr>
<td>Convert to non-profit</td>
<td>16</td>
<td>13</td>
<td>14</td>
<td>43</td>
</tr>
</tbody>
</table>

Total: 798 733 749 2,280

$^a$VND = Vietnamese Dong. 1 USD = 14,000 VND in October 2000.
$^b$Divestiture includes equitisation and other forms of privatisation (free transfer, sale, lease, and contract-out). As of June 2000, the five-year experiment has resulted in the equitisation of 421 state enterprises, of which 305 have sold more than 65% of their shares to non-state holders.


The current conceptualisation of the GC is full of ambiguities (World Bank, 1995). The definition of a ‘strategic’ sector goes far beyond public goods, or private goods that cannot be competitively provided by the private sector albeit with some assistance.

Furthermore, there is a multiplicity of principals (central, regional, industrial bureau or ministry), objectives (fiscal, social, efficiency), and roles (the state as owner vs. as regulator). In those sectors where SOEs enjoy monopoly power (such as cement and textiles), there are few safeguards against asset stripping and related non-competitive behaviour – a feature that is likely to be accentuated by the proliferation of such GCs.

6 The post-socialist DBG: model or muddle?

The foregoing review of the role of tightly-knit business groups in emerging economies holds valuable lessons for China and Vietnam, as they seek to establish comprehensive codes for group affiliation, mergers and acquisitions. The bottom line is that the unbundling of the largest State monopolies has to be done with great care. It should be designed to judiciously facilitate the emergence of competitive enterprises, including from greenfield privatisation, which can exploit the opportunities presented by domestic networks of varying tightness as well as global value chains.

Policymakers in the two ‘unorthodox reformers’ face a broad array of conflicting goals that are still shaped, to a significant extent, by the inherited industrial landscape (Steinfeld, 1998; Sachs and Woo, 2000; Lavigne, 2000; Tenev and Zhang, 2002). The main tasks involved in modernising the industrial structure include:
building up equitised financial and nonfinancial corporations with clean balance sheets, including the transfer of social welfare functions (housing, health care, education) to fiscally sound local governments

• identifying core manufacturers (and perhaps core banks) to lead economically sensible business groups, especially where the state is likely to remain an important shareholder

• permitting mutually beneficial affiliation between state and non-state enterprises as well as joining global value chains

• facilitating the emergence of supra-regional and inter-ministerial asset management bodies to stem coordination failure in the absence of sufficient market (or plan) discipline

• formulating enforceable regulations that ensure intra-group equity, foster inter-group competition, and create the proverbial ‘firewall’ between independent companies and politicians.

The foregoing review suggests another hypothesis concerning the Sino-Viet model of economic grouping. That is:

Well-regulated groups, led by strategically placed State enterprises, can serve as an effective organisational model for reducing transaction costs in a weak legal environment, channelling investment in strategic and complementary activities, sharing key resources via internal markets, pooling risk, exploiting market niches in the global economies, and facilitating State guidance with reciprocity.

A case can certainly be made against adopting a MITI-style, much less a Korean-style, strategic industrial planning in socialist East Asia. The litany of arguments for accelerating privatisation and marketisation are based on the need to fully appreciate the initial conditions of reforming China and Vietnam. The two transition economies have inherited an economic bureaucracy predisposed to command-and-control directives rather than to guidance planning; have contradictory policy goals of picking winners while shielding losers; cannot effectively insulate technocrats from political interference and corruption; and WTO rules preclude the kind of industrial policies followed by Korea in the 1970s. Grouping without aggressive privatisation would, therefore, amount to little more than reshuffling enterprises into clusters with little or no prospects for constructive change in managerial behaviour (see, for example, Perkins, 2001).

Jefferson et al. (2000), on the other hand, note that China’s foreign-invested as well as shareholding enterprises have failed to deliver significant productivity gains in the 1990s. That is because sustained growth of total factor productivity depends on a supportive economic environment (legal, financial and regulatory) and an enterprise system that would make hybrid ownership workable. There is, in fact, little or no evidence of a latecomer producing leading industries and national champions by eschewing government promotion in favour of rule-based, non-discretionary industrial policy (see Amsden, 2001).

Given the respectable economic record of groupwise diversification in wide-ranging emerging market economies, and China’s own tentative experiment with the jituan, the more fruitful question may have to do with identifying the right sequence of enterprise reforms that would facilitate the speedy emergence of a vibrant market for corporate control (see Stiglitz, 1999; Qian, 2000; World Bank, 2002).
Grouping in China and Vietnam may, therefore, be usefully approached in the context of two distinct phases of market-socialist reform. During the ‘phase-in’ period currently underway, the focus of reform has rightly been on ensuring macroeconomic stability, cleaning up of the bad debts of large enterprises and State banks, and laying down the foundation for the assumption of social spending obligations by local governments. The portfolios of business networks are to be strictly justified on the basis of potential net welfare gains in terms of scale, scope and learning economies. With less than a US$ 1000 of per capita income, the two countries, with a reputation for pragmatism, cannot afford to waste scarce resources on far-fetched experiments.

During the ‘phase-out’ period, the orientation of industrial policy must switch from selective to functional within the scope of what some consider are unduly restrictive WTO rules. Policy focus shifts to streamlining over-diversified groups, creating sufficient oversight over fragile capital markets, and undertaking deeper privatisation to stem asset stripping by State agents enjoying a powerful mix of controlling and income rights in mixed-ownership enterprises. A case in point is the resolution of the Central Committee (passed on 14 October 2003) to move China away from the policy of *zhuada fangxiao* (grasp the large, release the small) to one of controlling-private ownership and rules-based business environment (Tenev and Zhang, 2002). The State now intends to sell stakes in 190 State conglomerates (with assets of more than US$ 300 billion).

It would be fair to say that the Asian financial crisis has reaffirmed the findings of the econometric studies on DBGs. The very attributes that made business networks successful (such as economising on scarce resources, facilitating innovation, reducing financial risk, and countervailing power against a rigid bureaucracy) eventually become fetters, as markets become sufficiently developed and local firms become progressively integrated with the global markets. The ongoing cross-keiretsu mergers among historically fiefdom-oriented banks or tie-ups among rival trading houses in Japan, and the collapse as well as rationalisation of many of Korea’s chaebols point to the capacity of this model to evolve (Mody, 1999; Goto, 1982; Yafeh, 2002; Kim et al., 2004).

The Nipponean DBG, which relied neither on State shareholding nor on foreign direct investment, will have to be adapted to the needs of the State-dominated but FDI-seeking market economies of Southeast Asia as well as China and Vietnam. A nimbler cousin of the chaebol presents a more attractive transitional model worthy of imitation than the muddle that is the Russian FIG.

The phase-out stage, when completed, would probably leave a legacy of an efficiently diversified domestic industrial base. A variety of DBGs are likely to emerge across different ownership lines: State-State, State-private, and private-private. Where DBGs lack competitive advantage, other forms of networking such as clusters of specialised but complementary firms evolve into ‘industrial districts’ which is currently underway in the eastern seaboard of China with regional governments supplying the missing links (Barboza, 2004).4

### 7 Conclusion

This paper critically examined the relevance of the Diversified Business Group to the challenge of going beyond defensive restructuring or willy-nilly privatisation of selected large-scale SOEs in China and Vietnam. It suggests that suitably-adapted business
grouping is a promising model for large-scale State enterprises in the two countries at the intermediate stage of reform.

The primary advantages of groupwise diversification, a hybrid institution that melds elements of central planning and market competition, lie in converting the disadvantages of late development into an opportunity. It could help to overcome pervasive market failures (using closely linked supplier-manufacturer relations, internal capital markets, and investment in skills), high agency costs (via dominant ownership, close supervision and monitoring by key lenders), high risk (mitigated by affiliate and market diversification), significant barriers to cost-efficient acquisition and diffusion of technological information across firm boundaries (via coordinated negotiation and internal sharing), scarce managerial skills, and inadequate publicly-provided infrastructure (through self-provision and lobbying). On the other hand, poorly structured or regulated groups may bring potentially large welfare losses, including a propensity for rent seeking and unjustifiable access to State financial capital, stifling competition from small firms and foreign investors, and frustrating effective monitoring by lenders and stakeholders.

That is why the DBG is best viewed as a potentially effective transitional organisational innovation for promoting industrial deepening in those sectors where markets are too shallow, capital and entrepreneurship too scarce, and entry barriers into global markets too strong. If the two post-socialist reformers manage to develop groups that are relatively free of control by rent-seekers and rent-seeking oligarchs and corrupt apparatchiks, China and Vietnam stand a good chance of moving to the frontline of the ‘flying geese’ of East Asian development (Akamatsu, 1962).5

References


The diversified business group as an innovative organisational model


Notes

1The top 30 chaebols had an average of 616 affiliates while the top five had an average of 40 affiliates. Much of the growth for these fiercely competitive groups came from the establishment of new subsidiaries rather than from recruitment of non-affiliated firms. Even in Taiwan, not known for its industrial (firm) concentration, some 100 of the biggest groups accounted for one-fifth of manufacturing value added.

2Nolan (2002, p.121) sums up the nature of State support to selected SOEs, 11 of whom made it in Fortune 500 in 2001, this way: ‘China’s chosen global giant corporations were supported through industrial policies, which included: tariffs, which still were significant in many sectors at the end of the 1990s; non-tariff barriers, including limitations on access to domestic marketing channels, requirements for technology transfer and to sub-contract to selected domestic forms as the price for market access; government procurement policy; government selection of the partners for major international joint ventures; preferential loans from State banks; and privileged access to listings on international stock markets. Parenthetically, some two-thirds of the large stock of FDI (US$ 700 billion) that China has received in the past two decades went into the modern industrial sector – a sector that provides employment for over 40 million workers.
Although most of the 5,500 SOEs are quite small, Vietnam does not yet have anything comparable to China’s dynamic TVEs. Of the 2,280 SOEs planned for restructuring in 2000, some 380 were to be divested by 2002, of which fewer than 200 had assets valued in excess of one million USD. Average assets (fixed plus working capital) for the largest 100 SOEs are, however, valued at US$ 70 million – about one-tenth of the average size of 117 diversified firms in Indonesia (World Bank, 2000). The stock of FDI in Vietnam currently stands at about US$ 20 billion.

Industrial districts are regions that enjoy agglomeration or cluster economies where flexible specialisation, and competition over product innovation enable small firms to gain access to large domestic and export markets. National and local governments stem coordination failure by providing essential infrastructure and other business services. In the large textile and apparel districts of the Yangtze River, for example, ‘The Chinese government has played a crucial role, opening huge swaths of land for development, forming giant industrial parks, doling out tax benefits and developing the infrastructure and transportation networks needed to move products quickly to market’ (Barboza, 2004, p.3).

The flying geese (FG) model of East Asian development, proposed in the 1930s by Akamatsu (1962), posits a sequential and ever-changing division of labour between the industrial leader (Japan) and its followers. Efficient latecomers can move up, even leapfrog, the ladder of comparative advantage by using labour and resource-intensive manufacturing as a springboard for upgrading national technological capability.