

Product and International Diversification of Business Groups in China: Antecedent or  
Consequence of Superior Performance?

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## *Abstract*

*The term business group generally refers to conglomerate firms with multiple majority-owned subsidiaries and minority-owned affiliates, engaged in a diverse array of business activities.*

*A recent stream of literature explains the predominance of these structures, typical of the emerging and transitional, from socialist to market-based economies, as a result of their ability to neutralize market failures, and to act as substitutes for imperfect economic, social and political institutions. In emerging countries, interlocking ties among firms are often created in order to make available scarce or nonexistent material and immaterial resources, as emerging economies are unlikely to be endowed with the combination of factors that promotes entrepreneurial activity. According to this traditional view, the extent of product and geographical diversification of the groups leads to better economic performance in emerging and transitional economies.*

*A main question is whether this causal nexus, from diversification to performance, is confirmed, or actually reversed in the case of Chinese business groups, due to the historical and institutional contingencies in act during the evolution of these groups. Many of them were formed under the encouragement or active pressure of the Chinese government, which selected the better performing firms to acquire bankrupt state-owned enterprises in related industries. To better understand the nature of the causal link, the study has been integrated with further research focused on the modality and outcomes of the transition from traditional SOEs to business groups. The literature screened offered empirical evidence based on longitudinal data analyses that supported both views on the causal relationship between diversification and performance for business groups in China.*

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**Abstract**

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## **1. Summary.**

The term “business groups” normally refers to conglomerate firms with multiple, majority-owned subsidiaries and minority-owned affiliates engaged in a diverse array of business activities. Their size and breadth of interests can overlap or cover areas generally dedicated to a country’s set of institutions. Until recently, a widely accepted line of research attributed the dominance of such firms to institutional voids in emerging markets, with this strategic form of organization playing the role of micro institutions addressing the weaknesses in the governance systems of developing countries. In fact, emerging economies are unlikely to be endowed with the combination of factors that promotes entrepreneurial activity; successful entrepreneurship efforts are the outcome of the coincidence of functional market structures, availability and quality of financial and human capital, cultural propensity to support and regulate success and failures, and adequate property rights protection (Kummerle, 2005).

A major proposition of the research is that the extent of product and geographical diversification of the groups leads to better economic performance in emerging and transitional, from socialist to market based, economies. Amongst the other benefits of the size and scope, a more diversified firm is more likely to have sufficiently large internal capital and labor markets, and to make them function efficiently, supplying this way the efficient flexibility of resources, coupled with contained costs, essential for a successful growth process. Furthermore, the literature recently focused on the comparison between unrelated diversification and related diversification, seeing the second outperforming the first. About this last point there is no unanimous consensus; when jointly considered, both diversification strategies will add up in their contribution to the system’s growth (Li and Wong, 2003).

This idea has also been applied to the analysis of business groups in China, but extant empirical findings have given rise to more questions than answers.

A main question is whether the proposed causal relationship – diversification leading to better performance – is in fact reversed in China, because many of the Chinese business groups were formed through a selection operated by the state, which also provided assistance for supplementing the group’s bureaucratic structure. These groups of firms, characterized by the presence of a core firm, are historically often a consequence of the Chinese government’s policy to encourage and sometimes pressure better-performing firms to acquire bankrupt state-owned enterprises in related industries, moved often more by social stability concerns than by profitability rationale.

Policies aimed at promoting group affiliation under a strong performing State Owned Enterprise (SOE) became evident, particularly with the economic reforms undertaken after the ‘80s, when the state promoted the creation of the so-called national champions, or groups centered on exemplary firms, to promote the growth of strategic industries locally, and their image globally.

To better understand the nature of the causal link, the study has been integrated with further research focused on the modality and outcomes of the transition from traditional SOEs to business groups, passing through the form of shareholdings corporations, and including the effects from observations on the role of private groups.

Part of the literature screened offered empirical evidence based on longitudinal data analyses that supported both views on the causal relationship between diversification and performance for business groups in China.

By classifying Chinese business groups into different types based on their institutional heritage, the research incorporated some critical institutional factors into the analysis and thus improved theoretical precision in this stream of research.

## **2. Significance to International Business**

The main propositions of the study are significantly different from those that are often widely accepted in the field of international strategy and business. Its findings are expected to reflect recent relevant theoretical analyses for understanding the nature of business groups in emerging economies and their impact in the global economic scene.

In order to analyze the topic of growth in transitional economies, the Chinese groups' framework, for the size of sample and political affinities with other emerging economies, well exemplifies a prevailing strategic choice, although its business group developmental model also presents unique traits. Studies of comparative corporate governance will have to include analyses of the new form of capitalism involved, often labeled as state capitalism, to provide models that better reflect the fast-moving Chinese business environment.

Findings on these new organizational structures furthermore challenge existing theories on multinational enterprises (MNEs); theorizations on business groups sustain that not only firm's scope, product and geographical, but also state involvement matters to promote development and growth (Yiu, 2010; Haveman et al. 2013). China recorded momentous

geographical business expansion, with business groups accounting for most of the country's outward foreign direct investment.

The line of research has important practical implications, both for the evaluation of diversification strategies and for government policies with regard to the development of business groups in emerging and transitional economies, offering a different insight to foreign entrants in the Chinese market. The study of the characteristics of these entities is functional in the process of deciding which Chinese business group to join, or the nature of competing firms in a foreign market.

### **3. Strategic role of groups to the growth of the economy in developing countries**

In developing economies, particularly in transitional economies, those changing from a centrally planned to a free market system, the uncertainty that characterizes the process of transition to market liberalization tends to produce an initial increase in the scope of business that in turn naturally brings firms to converge into groups, while conglomeration, or unrelated product diversification, in developed economies tends to destroy value (Khanna, Palepu, 2000; Peng et al., 2005).

Policies enacted by the state to promote economic growth also generate opportunities for existing successful firms; the consequent development momentum acquired by incumbents, and state assisted firms, fosters a growing, powerful corporate sector (Carney, 2008).

Until recently, most of the early empirical literature on the emergence of business groups in developing economies focused on their evolution as substitutes for imperfect economic, social and political institutions; these collections of firms are bound together entities created in



response to system inefficiencies, in terms of capital, labor, talent and technology market failures, and distribution problems.

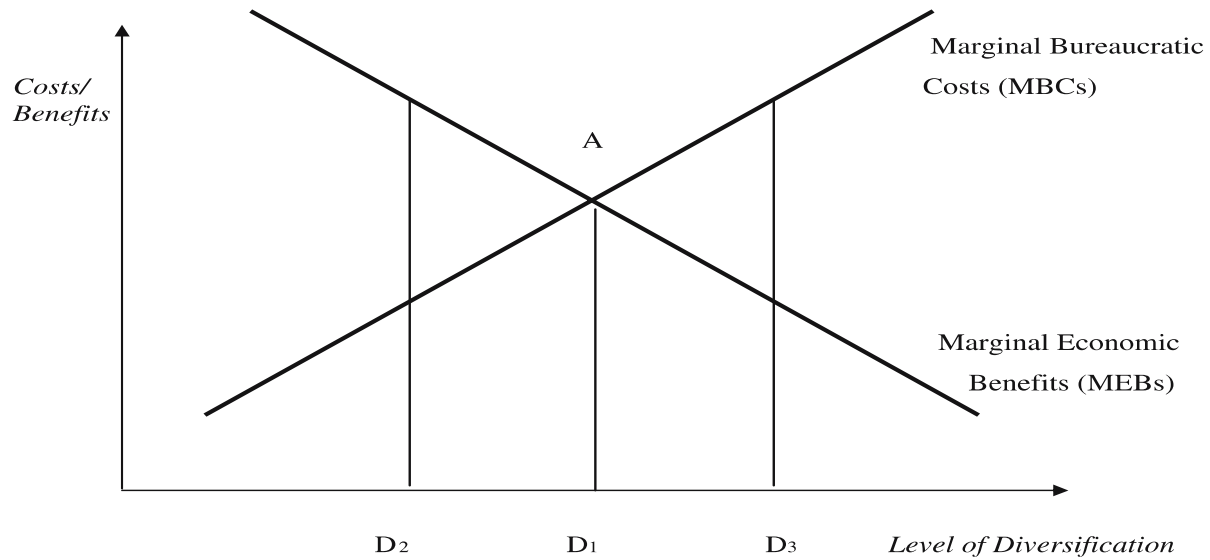
In emerging countries, interlocking ties among firms are often created in order to make available scarce or nonexistent financial and legal services, to facilitate the flow of information and exchange managerial expertise, to neutralize the perverse effect of risk, and to secure property rights guarantees. Crucial in the economic justification of business groups is the release of an internal functional capital market, instrumental for the achievement of scope and scale economies and of central coordination services in developing markets.

Peng, (1997, 2003), integrating approaches to firm growth theory, underlines that in developing economies, particularly in those undergoing a transition from central planning system to market competition, that to promote sustainable growth, a firm must build up strategic resources. A key concept remains that in advanced economies transaction costs are mitigated by the efficient functioning of the financial markets, where also firm ownership and property rights transfer is guaranteed by the existing and working institutions, inducing a successful, smooth process of acquisition.

In emerging economies, to promote growth, together with the firm's ability to neutralize market failures, it is crucial the role of available skilled management, capable of supplying relationship networks. The main aim is to counteract those institutional inadequacies, balancing transaction costs and assisting access to capital, to obtain new levels of efficiency in order to compete in a global environment, and to achieve innovation and increase savings (Hoskisson, 2005; Carey, 2008).

These types of economies are manifestly characterized by poor infrastructures, and policies dictated by the interaction of formal and informal institutions (defined by Helmke and Levitsky, 2003, as “the actual rules that are being followed”). The role of the state, main economic actor in this initial stage, is to release resources and information flows in support of strategic industries, and, through licensing and permissions, guarantee rights to protect and strengthen the position of local players initially, acting in a later moment as stimulus for innovation. The two types of infrastructures can be complementary and compatible with one another, producing economic environments apt, if not to enhance performance or supply services, then at least to allow a better functioning of the existing formal institutions, as happens in liberal market economies. In contrast, in developing countries formal and informal institutions often work against one another and their goals might be incompatible. For example, Russia displays an ill - functioning economic system due to those goals’ discrepancies, while in China its substitutive informal institutions, the business groups, act coherently with the formal institutions’ goals, filling the institutional voids gap (Estrin, Prevezer, 2011).

The microeconomic analysis says that during the economic expansion process, the newly formed industrial system develops around mainly acquired generic skills, with little or no proprietary competences, resulting in non-specialized, broad production, and leading to economies of scale and scope. At this stage, the main aim is the achievement of production efficiency toward the technological frontier, containing costs to attract market shares, but keeping in mind that to increase the product scope means to incur additional costs to manage the organization.

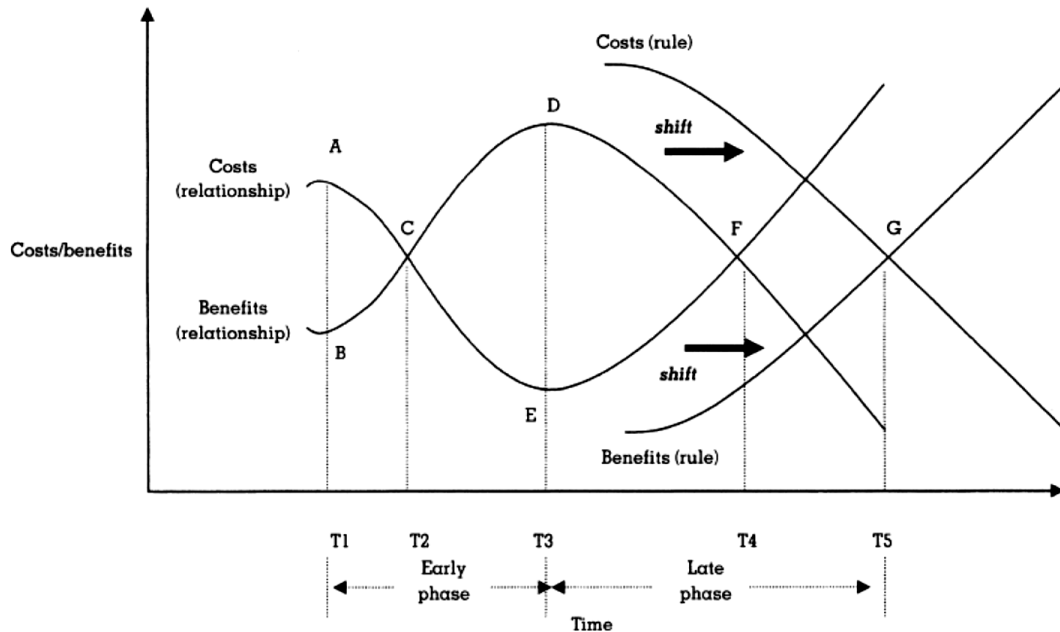


**Figure 1** Basic drivers of the scope of the firm. (Jones & Hill, 1988, p. 166)

In Figure 1, the relation described by the technology frontier implies that higher level of positive synergies due to an additional unit of growth, for example an acquisition, will be associated to higher costs to manage and coordinate the new, expanded structure. The A equilibrium gives the optimal size; further growth (D3) would incur inefficient levels of MBCs.

Size and breadth of a firm's economic activity matters, favoring and benefiting firms' affiliation structures over single players in the market. Later, the evolution of internal institutions coupled with state impulse can assist the group to develop the specific competitive advantages that characterize firms capable of competing in the global market.

### A Two-Phase Model of Institutional Transitions



In the Two-Phase Model of Institutional Transition, the shift to the right of the cost-benefits graph, as illustrated by Peng (2003), indicates the transition, through incremental evolution, to a new-rule based phase, or mode of exchange, with reduced uncertainty granted by the evolution of institutions. The evolution of new institutions is bound to produce in time new costs and a period of institutional turbulences. T1 is the time when costs of transactions are high while benefits are low. It is necessary to build strong social networks in order to reduce costs and increase benefits moving toward C and a further positive transactions structure; from T2 to T3 the economy benefits from relationship - based, non-formal contracting. In T3, to guarantee growth, the complexity of the new transaction system requires a shift to a new mode of production, which considers the new institutional changes; if this shift does not happen, group affiliation will still be beneficial, supporting the firms through this period of instability.

Depending upon the initial societal asset in place in the country, forces might act in the opposite direction, opposing resistance to drastic economic, and therefore political and social change, these forces act to maintain a privileged status quo, slowing down the process of liberalization or producing hybrids. Informal institutions, essential to supply market alternative instruments, often have a problem-creating role, via corruption, clientelism and lobbying forces. For example, during fast economic development in Brazil, attempts to preserve privileges and power led to poor governance effects, reflected at group level in excess of non-voting shares (exploitation of small shareholders) and poor company performance, frustrating the efforts to establish a functional capital market; only recently have enforced legal reforms restored confidence in the market.

In Russia, corruption and lack of transparency hindered the initial efforts implemented in the '80s to build a western style, market - oriented economy. Recent compliance with OECD standards has seen improving Russian accounting and judicial structures, and reforms are still undergoing; however, formal compliance with international requirements does not imply a corresponding effectiveness of the measures in a country still plagued by lack of enforcement and corruption (Estrin, Prevezer, 2011).

China, on the other hand, according to a relevant part of the economic doctrine, is producing a liberalized market influenced by the importance of political players at the local and centralized level. For example, there is an available working capital market, whose access is facilitated for those firms enjoying solid bureaucratic connections; the labor market also is evolving and acquiring mobility, but still has to satisfy the requirements to maintain the harmonious socialistic society formally invoked since 2006.

Crucial to the understanding of the Chinese groups' evolution, interaffiliates benefits distribution, and structure and performance causality mechanism, is the role of variables like the contribution of the state, the nature of affiliation, and the ownership typology.

#### **4. Business groups in China (qiyejituan, 企业集团) as centrally coordinated organizations.**

The China National Statistics Bureau (Chinese Government) defines business groups as a collection of legally independent entities that are partly or wholly owned by a parent firm and registered as affiliated firms of that parent firm; cross-ownership among affiliates is frequent. A broader definition includes the concept of collection or network of legally independent firms bound by coordinated economic and social, formal and informal ties (Granovetter, 1994). The links can be generated by different aspects of the production process, like cross or common ownership, interfirm products or resources exchanges, and financial ties, or dictated by social relations, like family, community or personal friendship.

These strategic affiliations of firms, although similar to networks of firms and multidivisional groupings, differ because they are composed of independent legal entities, and present strict central coordination and financial and strategic dependence among affiliates.

Strong advantages derive from the availability of developed distribution networks, and the circulation of technological innovation, brand names and marketing skills, elements that Yiu (2010) assimilates to ownership advantages, bound to benefit the network of firms, including the weakest components.

Group membership, through inter-organizational relationships, assists the distribution of fixed costs for professional training, makes possible the reach of the available information about

products and transactions, and spreads group reputation benefits, both in terms of brand name and trust, and of credit ratings, making available a good-practice and reputation premium to all the affiliates. The firm's development and performance achieved, assisted by such a network of connections, is the result of generic expansion and internalization (Peng 1997).

In a country like China, that formally recognized property rights only in 2004, with poor legal infrastructure and contract enforcement, and where management independence is normally difficult to maintain, the creation of an organizational structure, large enough to enjoy scale and scope economies, allows firms to efficiently bypass the institutional voids created by the scarcity of infrastructures otherwise guaranteed by advanced, functional governments. Groups also offer the type of soft infrastructures defined by Khanna and Palepu (1997) as the set of support services and actors that facilitate business operations, such as market research firms, training programs, research and logistics providers, executive recruiters, technical standards committees, product certification, and financial verification. These corporations supply to their affiliates the flow of information vital to the efficient conduction of business operations.

Especially in transition countries, these organizational structures not only supply material and immaterial resources and services, but often more importantly act as buffers between political, social and economic powers, justifying a large support from the existing institutions that often promote their same creation, and grant them privileged allowances. In fact, while engaged in the affiliates' growth, the group often contributes to social advancement and provides resources and services instrumental to economic progress.

Business groups act as resources providers for the associated firms and as intermediaries with state institutions because a group thrives on the basis of its ability to leverage institutional

relatedness. High institutional relatedness, as the degree of informal embeddedness or interconnectedness with dominant institutions, means that is present the dense network of ties and system of social connections with dominant institutions known as guanxi (Peng, Lee, and Wang- 2005).

The tight connection with the state administration is of high interest to foreign firms willing to gain access to the Chinese market, as the widely connected business groups, more than single firms, attract entrants, offering the perspective of benefiting from state support. Consequent alliances with foreign firms allow positive bilateral exchanges, where the foreign entrant gains access to local business networks and established relations, while the business group acquires learning opportunities and links to foreign markets, implying that group membership rewards its components not only through the preferential connection with central and local government, but also releasing potential benefits from foreign collaborations.

Khanna and Palepu (2000) observe that the generic market-related reasons that justify the formation of the groups should be integrated by country - specific circumstances. In the case of China, other country - pertinent factors should be taken into account, such as the level of protectionism or the degree of competition. These factors affect the formation of business groups not only at a national, but also at a local level, as a consequence of the characteristic autonomy achieved by the provinces through the decentralization years.

Taking into account that the aggregation of firms around the world assumes different forms, according to the prevalent economic, political and social conditions, the most prevalent market-oriented justification to the emergence of business groups in China has been integrated by studies based on state activism and firm endowments. This current trend of thought suggests



that a different grouping mechanism can be triggered by responses to market changes and to diverse state policies, or by the need to optimize the firms' internal resources in order to release its full growth potential (Penrose, 1995). As indicated by Xinqin and Xu (2011), because of its advantages, a business group can assume a privileged, successful position when the target is entering a new business or market.

However, it would be reductive to justify Chinese business groups only as micro institutions, created to supply solutions to market voids. Chinese history, since the beginning of the economic reforms in 1978, suggests an evolution in the firms' aggregation forms, encouraged and facilitated by the state.

As suggested by Lee and Jin (2009), this approach develops previous studies and analyzes mainly strategic choices during the phase of transition from SOEs into business groups passing through the form of shareholdings companies<sup>1</sup>. They argue that business groups are prevalently composed of firms that previously enjoyed higher autonomy, faced a higher level of competition, had bigger size, lower indebtedness and better connections with the state, implying that only the champions in the market could be successful candidates for the ambitious state policies' attention. The group therefore would form around highly successful firms capable to share their growth potential with other affiliates, resulting in a highly successful group.

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<sup>1</sup> The doctrine generally accepts the assimilation of business groups into conglomerates; nonetheless Lee and Seog, (2008) introduce a main distinction that should be taken into account. The limited liability characteristic of a business group subsidiary favors an investment approach more aggressive than in the case of conglomerates' divisions that show higher risk aversion.

Those are not, however, the sole variables characterizing the likelihood for firms to aggregate into business groups: other specific factors are linked to the path assumed toward the new form, whether carried out through mergers and acquisitions (M&A), spin offs or joint ventures (JV), as stressed by the China Academy of Social Science. According to this view, a firm's association in groups is not a mere passive reaction to market conditions, indicative of *per se* exogenous factors, but more a rational catch up instrument, mostly controlled by the government, to promote and speed up economic growth, and to make it easier to penetrate new markets or lines of business.

A group can provide financial, technological, marketing and distribution assistance, and production support: in order to achieve this performance, the state should be active with favorable financial and fiscal policies. As a consequence, the firms that mostly benefit from affiliation are the weakest or the new entrants in a business: also, firms with more invasive state ownership benefit more from the affiliation (Carney et al, 2009).

Carney (et al., 2009), also maintain that affiliation with a business group is advantageous insofar as it provides diminishing transaction costs granted by mutual contributions. Outlining the findings of recent studies, the authors state that while it is true that the strategic organization of firms facilitates access to scarce resources, and makes available close ties with both interfirms and governments, it is also true that the advantage provided declines over time. The rationale for groups' affiliation, based on the initial market failures, is diminished by the creation of formal institutions, as a natural and logical consequence of the advancement.

Part of the literature, however, identifies business groups as autocratic corporations. According to this view, these groups aggregate with the aim of extracting rents, and despoil

minority shareholders and subordinate firms. The beneficial effects of concentrated ownership, primarily to reduce or eliminate the principal-agency problem, and to obtain a faster decision making process, can give way to perverse behaviors: membership in these groups can be detrimental, with observed tunneling behaviors, where corrupt management sets manipulating practices that function for its own benefit. Examples of these actions can be observed, especially in the case of listed firms, in certain mergers, block share sales at prices non-reflecting the value of the company, or any transaction that from a subsidiary tends to transfer resources or financial assets (for example loans) to the controller without a corresponding realistic valuation.

Furthermore, heavy government intervention and managers formed on central-government culture can inhibit innovation, and therefore competitiveness, to preserve employment: for example, the objective of harmonious growth pursued by the government makes layoff policies unpalatable for Chinese managers. Business group strategies might then result, consequently splitting into two categories, those linked to the central government culture, which tend to prevent social unrest at the cost of innovation, and those following a market approach, whose aim is to maintain and grow their market share in the increasingly competitive local and international market. Hoskisson(2008) reported that a recent trend wants to combine the two apparently conflicting economic and social aims, with business group managers moving towards a market-oriented mentality.

## **5. Chinese business groups and business groups across developing countries**

The nature of the groups across countries differs for the prevailing cultural factors, the typology of connections among the composing firms, and the kind of affiliation that can be sanctioned formally or through informal social interconnections. Chinese strategic alliances are characterized by strong group culture, based on informal norms, and solidarity standards and trust, where even the core firm location matters. Interpersonal connections (*guanxi*) and family links are at the basis of successful social-professional economic networks, with particular directions imparted by the hand of the central or local governments. Also in China, as later indicated for other developing countries, defining the ultimate ownership of a firm and eventually of a group can be an issue, because of the high concentration of ownership and inside investors peculiar to these pyramidal structures.

Compared to the business networks that developed in other countries, Chinese business groups present a lower degree of diversification, despite being composed often by firms apparently involved in unrelated industries. In fact, alliances with firms exposed especially to services and with welfare functions, are historically connected to the characteristics of the Chinese planned economy, where the responsibility of the state also involved the social-welfare aspect: exposure to those sectors (for example managing restaurants or schools) was therefore a requirement (Ma et al., 2005).

A closer review of the groups formed in the past two decades would reveal pertinent upstream and downstream firm's connections, as dictated by the state aspiration to create powerful local and international industrial scene competitors.

The participation of affiliated companies can be different elsewhere, depending upon the influence of institutional investors, individuals, banks, and families. Around the world the prevalent form of business groups is aggregation of family controlled firms; these organizational structures are common throughout not only Asia, but also in most developing and transitional economies in the world. Chinese business groups were formed initially following the success of the Korean and Japanese aggregations, and were later developed, focusing on a more Western model (Lee, Hahn, Lin, 2001), with central planners devoting particular care to contain poverty levels. Chinese business groups and the other Asian counterparties are characterized by their own traits, involving mainly the stronger participation of local and central government into the entrepreneurial activities.

### *Japanese Keiretsu*

In Japan, according to the model of government-guided capitalism (Baumhol et a. 2007), state authorities also actively intervened to form the local Keiretsu, intrinsic product of an administered economy (Carney 2008). Japanese Keiretsu differs from the parallel Chinese structures because there is not a centralized decision - making mechanism like the pyramidal structure of the business groups. Japanese groups are more interlinked companies, with corporate ownership often coordinated by a leading bank, while in China commercial banks cannot become shareholders of firms: the state controls enterprises and banks that consequently have no incentives to monitor a firm's performance, and bank loans are granted preferentially to state-owned groups, with restrictions to loans access for privately owned or risky business.

In Japan, managers and bureaucrats formed in the same elite schools where they developed ties that will produce professional bonds and affinities. The consequent strong

common corporate spirit, justified by the Japanese societal asset, develops high levels of loyalty to, and pride for the group, which mediates between the state necessity to govern and the market-oriented company decisions. State intervention does not come about only through expressed intrusive policies, but can develop in symbiotic relationships involving the political and economic sphere (Evans' embeddedness, 1992).

### *Korean Chaebol*

In Korea, the typical affiliation structure, the chaebol, is the outcome of strong state intervention; it was conceived between the 1960s and 70s under Park Chung Hee, with the intent of promoting a modern industrial state. A chaebol is represented by a group of firms under the control of one family giving financial and administrative direction; the structure contemplates owner families at the top, core holding companies on the next level and all other affiliates at the bottom. They are characterized by hierarchical management structures and complex dynastic ownership. Both Chaebol and Keiretsu were powerful means to challenge foreign firms' ambitions to penetrate local markets; consequently, both are also controversial means to retain economic power in the hands of elites and elected families. These companies, through state intervention, enjoy a protected market, easy access to financial resources by guaranteed relations with banks, and favorable, tailor-made industrial policies.

In Korea in particular, the success of these group affiliations has brought about the successful creation of industrial concentrations of economic power. In 2010, according to the Federation of Korean Industries, the value of exports by the 30 largest chaebol accounted for 84 percent of the country's overseas shipments (Bloomberg 2012), and by December, 2012, the top five chaebol, controlled assets worth 57% of GDP (Reuters, 2012).

The power accumulated and exerted by those industrial agglomerations, however, brought to the attention of the public the high level of government and business collusion (The Economist, Mar. 2010). Political leaders, on the occasion of the presidential elections in 2012, acknowledged the cost of the rapid concentrated industrial success in terms of increasing difficulties for small businesses to thrive, a widening income gap, and the highest suicide rate in the developed world (Yoon, 2012).

### *Indian Trading Houses*

Indian Trading Houses are another product of state-administered capitalism, although in India groups are granted fewer benefits than their Chinese competitors (Singh, Gaur, 2010); the social and political environment facilitated the formation of private groups. Indian economic assets tend to reflect the structure of oligarchic capitalism, dominated by business groups so large and powerful that often inhibit the economic ability of other firms (Steier, 2009).

The emergence and success of groups in India is justified not only by market failures, but also as a side effect of perverse economic policies that interfered with the firms' growth: strict licensing, state restrictions, and weak and shallow capital markets regulated private businesses' expansion. For explicit regulations, and because of the lack of external institutions supporting entrepreneurial activity, the only way a firm could grow was diversifying its activities.

A single family that controls and owns significant shares of listed firms in broadly diversified businesses characterizes most of the structures of these groups. As asserted by Peng and Jiang (2006), the high family ownership concentration has positive effects when legal institutions are weak. The vast territorial expansion of the state has also justified regional

differences, with difficulties in enforcing rights and implementing measures efficiently in different regions (Estrin, Prevezer, 2010).

In India, the unification of ownership and control is more common than in China, due to the prevalence of private groups and of family - managed firms. Family or individual ownership indicates that the undiscussed strategy for Indian groups is profit maximization, while for the Chinese counterparts, characterized mostly by state ownership, we have seen that social goals might be privileged.

### *Russian Business Groups*

Russia's transition, also characterized by the presence of both private and state-owned business groups shaped into oligarchic financial industrial groups (Carney, 2008), was marked instead, since the beginning, by strict adherence to Western design and institutions, but without the cultural, social and political background apt to sustain the changes; the consequent rapid economic growth brought widespread poverty and widening of the gap between the haves and have-nots. The negative connotation generally attributed to the term oligarchy and oligarchs by the international press when referring to the Russian economic system and operators, although this trap should not affect the semantic original meaning of the economic-political definition of oligarchy, stems from the opaque pyramid mechanisms easily allowing to conceal the identity of the concentrated shareholder, which the dominant investors use to exercise control.

Russian economic growth since the 1990s has been characterized by the failure of the rule of law and weak judiciary system, allowing managers to conduct business through legal but also illegal means, and concentrations of undeclared insider investors. This unclear ownership system, failures in law enforcement, and minority shareholders protection contributed to the



OECD demanding in 2005 the adoption of international standards to bring Russia to the status of a “high compliance” country (Estrin, Prevezer, 2010); nonetheless, perverse prevailing practices, like the lack of enforcement and the gap between the reported economy and the effective real economy, still impede the efficient working of the formal institutions in place. (Further hostility to foreign intervention and investment is also transparent in some of the regulations: for example, it is rare for any company to have available in the market more than 20% of its shares in free float.)

Although similarly relying upon informal institutions, Russia differs from Chinese development because the goals of its operators are conflicting, while in China state and company owners are generally oriented to fostering economic growth.

### *Brazilian Grupos Economicos*

Most Asian developing countries adopted group strategies to facilitate growth; the administered capitalism model was also followed to protect industries in Taiwan, Singapore, Indonesia, the Philippines, and most South East Asian countries. Similar structures can also be found in Italy and Turkey. In Latin America and Spain they assume the name of Grupos Economicos. These last have in common the rationale of facilitating development and growth, and are often led by charismatic entrepreneurs; like the Asian groups, they are active mainly in crucial local sectors (utilities, beverage, publishing, construction and coffee industries).

Groups in Brazil particularly have represented a growth strategy in the pervading bureaucratic environment and the law-ridden system, with the consequent formation of a parallel freer economy, mainly to access means of financing. Entrepreneurial activity is difficult in an

overregulated environment, especially for starting a new business, hiring and firing, or the complexity of the tax system, forcing economic operators to rely upon black markets.

The difficulty for small and micro firms, not only to access external funds, having then to rely upon internal funding and insider investments, but also to obtain bank loans, has justified the tendency to form groups. The institution of the Novo Mercado in 2004 was meant to facilitate access to equity markets, allowing at least in principle for firms to benefit from external investors funding; changes of control are apparently clearer, but there are still obstacles to takeovers.

## **6. Evolution of business groups in China.**

Although business groups in every country have some distinctive characteristics, the unique institutional environment in which China's business groups developed conferred on them a number of important differences from their counterparts in most other emerging economies. These differences are likely to make it problematic to explain their formation and rationale with exactly the same theories that have been found productive in analyzing business groups in other countries.

This research project critically examines the relationship between product and international diversification among Chinese business groups and their economic performance. To understand why the causality nexus between scope and performance could be reversed in Chinese business groups, it is necessary to review the rationale behind their institution and their connection to prevalent political-social forces.

Precursors of the modern business groups can be found in the Hong Kong and Taiwanese (guan xi qi ye) form of alliances among family firms. However, the characteristic lack of unified management direction and indistinct ties of the family coalitions do not allow for a close link to the post war, mainly manufacturing-based groups (Chung 1998; Hamilton, Kao 1990); before the beginning of the economic reform in the late 1970s, this last prevailing typology of companies in China was characterized by dependency from the central planning authority and strict government control.

Firms, such as SOEs and collective firms whose growth was strictly limited by government restrictions, were under the control of various industrial ministries or bureaus at the national and local levels. Each industrial ministry or bureau managed, through a system of interlocking relationships, a wide range of state-owned and/or collective enterprises that were in some way related to the industry segment of the ministry or bureau (e.g., electronics, machine building, or chemicals). The primary objective of the firms was not their performance, but the set of social and political priorities indicated by central and local government.

Economic reforms were introduced starting from 1978, and the Chinese Party Central Committee initially promoted forms of cooperation between SOEs similar to those of the Japanese Keiretsu, to later allow the creation of non-state owned economic entities. The reforms were aimed at setting incentives at firm level, with the parallel effect to improve the firm's decision-making structures, and at implementing policies to increase the level of firm autonomy from central government. The composite finale purpose was to provide incentives to improve the firm's performance.

This first set of reforms and the following, approved in the 1980s, were frustrated by the ambiguity between the state and the firm's management property rights, which created an opportunity for complicity and connivance between central government representatives at the local level and the firm's administration agents. The failure is attributable to the difficulty to consolidate and dispose of unprofitable parts of the business, and to the short-term profit strategies implemented. The group was then formed prevalently by horizontal association of firms, where the affiliates had similar status in the same or different sectors of businesses; their interest in joining was to share production facilities, brands or distribution/marketing channels coherently with the theory based on the insufficiently developed market mechanism.

By the late 1980s new reforms brought the adoption of the corporation form, introducing the separation between ownership and control through the shareholdings system; groups started to form through spin offs, mergers and acquisition of shares (Lee, Jin 2009).

In 1986 the term business group was officially introduced to define the forming economic entities, indicating the state commitment to support these frameworks as instruments of economic and social policies; in the following years the central government formally sanctioned the business groups, establishing incentives to the institution of state-owned affiliations, namely formed by SOEs, with the aim of exposing a specific sector to foreign markets or acting as a catalyst for the rescue of underperforming minor SOEs. In particular, the 1990s were characterized by these emerging figures of state holding companies; later the widespread pursuit of collective interests induced the state to adapt its policies further in favor of these institutions (Lee and Jin, 2009).

Private groups, often formed by the initiative of powerful SOE managers, or non-state entrepreneurs, started to emerge after the socialist market economy was instituted in '93 (Ma, 2005). At the beginning of the reform, and up to the mid 1990s, the lack of recognition and legitimate support for individual businesses, which practically disappeared in the 1950s during the socialist reconstruction, led private managers to enter into agreements with local authorities, to assimilate private businesses to cooperative forms, according to the practice referred to as wearing the red hat.

Because of the Chinese political asset as a decentralized federal state, the group's number increased exponentially with aggregations promoted not only at the central level but also by provinces and municipalities. The consequent high number of participants, which often lacked critical mass or rational justification (Shapiro et al., 2009), triggered the need for consolidation and direction policies from the central planners.

After the 1997-98 Asian financial crisis, the effort of the government was aimed at supporting large groups in key sectors, bound to compete and succeed internationally; this effort was further enhanced by the policies implemented in China to comply with the requirements to enter the World Trade Organization, in 2001. For example, the establishment of the "State owned Assets Supervision and Administration Commission of the State Council" (SASAC), had the intent to create a central level shareholder for the state enterprises. The main result was that state-owned businesses' control and coordination structures were strategically simplified. It was and is in the state interest to protect and facilitate its investments in these party-owned groups (Ma, 2005).

As the country's economic reform progressed, the state-owned or collective enterprises faced increasing competition from foreign-invested enterprises, mostly joint ventures in the

initial stage, and indigenous entrepreneurial startups; some of them were able to stand up against the competition and grow rapidly, along with the foreign-invested and private enterprises. The majority of them, however, fell further and further behind in terms of technology and market share, suffering mounting losses, and becoming a serious drain on the national economy.

The government faced a challenging dilemma at the time, because it did not want these enterprises to go bankrupt, fearing that the possible layoffs would spark social instability, nor wished to engage openly in large-scale privatization due to ideological bias. The challenge was to transform these largely inefficient state enterprises into product-region diversified and successful firms' affiliations, apt to face the growing local and international competitive pressure, and enhance internationally the country's economic image.

One of the principal approaches the central government adopted to improve the efficiency of the lagging state-owned and collective enterprises was to foster the growth of business groups. So the trend that started since the mid to late 1980s, with the intent to develop rapidly the Chinese economy, accelerated, producing by 2006, in official records, about 2,900 groups, with nearly 28,000 first tier affiliates, and supplying employment to around 30 million people in China (Guest, Sutherland, 2009); among those groups about 100 were selected to represent the “national champions” in key strategic sectors.

**TABLE 1: Institutional Reforms in China**

<b>General Economic Reforms</b>	
<b>Time Line</b>	<b>Key Reforms</b>
Stage 1 (1978-1983)	<ul style="list-style-type: none"> <li>• Initiated during the third plenum of the 11<sup>th</sup> Chinese Communist Party Congress held in December 1978.</li> <li>• Ideological shift from abolition of markets to accepting markets as secondary with planning being the primary tool of economic well being. Specific steps included: <ul style="list-style-type: none"> <li>• Agricultural reform by the introduction of household responsibility system, which made house holds residual claimant on the agricultural produce.</li> <li>• Gradual opening up of the economy beginning with Guangdong and Fujian provinces, and establishment of special economic zones, which were allowed to become market economies dominated by private ownership.</li> <li>• Partial fiscal decentralization, which encouraged some fiscal responsibility at the province level.</li> <li>• Reforms in SOEs.</li> </ul> </li> </ul>
Stage 2 (1984-1993)	<ul style="list-style-type: none"> <li>• Market liberalization through a dual track approach. SOEs could sell excess produce at market price after fulfilling the planned quota.</li> <li>• Introduction of contract responsibility system for SOE reform.</li> <li>• Financial reforms through bank decentralization.</li> <li>• Further opening up of the economy through coastal open cities, and development zones.</li> <li>• Entry of private and collective firms.</li> </ul>
Stage 3 (1994 onwards)	<ul style="list-style-type: none"> <li>• Objective was to transform China to a “socialist market economic structure” and build a rule based system.</li> <li>• Unification of exchange rates and convertibility on current account</li> <li>• Restructuring of tax and fiscal system</li> <li>• Reorganization of the central bank</li> <li>• Downsizing of government bureaucracy</li> <li>• Privatization and restructuring of SOEs</li> <li>• Constitutional amendment to allow for private ownership.</li> </ul>
<b>Corporate Governance Specific Reforms</b>	
<b>Time Line</b>	<b>Key Reforms</b>
1994	<ul style="list-style-type: none"> <li>• Introduction of China’s Company Law.</li> </ul>
1998	<ul style="list-style-type: none"> <li>• Introduction of China’s Securities Law to regulate capital markets and trading activities.</li> </ul>
1999	<ul style="list-style-type: none"> <li>• The Company Law was amended.</li> </ul>
2002	<ul style="list-style-type: none"> <li>• Code of Corporate Governance for listed companies released.</li> </ul>

Source: Gaur (2007)

Beginning in the '80s, business groups took shape primarily via the following three 'methods:

1. Wholesale transformation of existing industrial ministries/bureaus (or parts thereof) into partially state-owned business groups, where the dilution of state shares mainly resulted from employee stock ownership and initial public offerings.
2. Government encouragement, or even coercion, of successful state-owned and collective enterprises to acquire their money-losing counterparts in the same or related industries, forming a state-owned business group. This common strategic aggregation of firms counted on paternalistic policies by the central regulator, which was also the main investor.
3. Some successful private enterprises that started as individual proprietorships (called "Ge-ti-hu" in Chinese) also diversified into related and unrelated fields through acquisitions and organic expansions, and formed business groups. Entrepreneurs, who started firms and later groups, came from the ranks of professionals, specialists-technicians, and even farmers; their characteristic was a positive risk-taking constructive attitude, and close acquaintance with the network of relationships vital to successfully perform business activities. Several analyses have sustained that the role of the private sector has been penalized by policies implemented by the government, which actively sustained state-owned enterprises (Xu, Wang, 1999).

According to government statistics, business groups accounted for nearly 60% of the country's industrial output at the turn of the 21<sup>st</sup> century. The complexity of the political and social environment contingent to their development, and the distinct means by which business groups were formed in China, endowed them with a number of unique characteristics, making it potentially problematic to explain them with exactly the same theories that have been productively employed to study business groups elsewhere.



Business groups are characterized by continuous evolution and their complexity is underlined by the adoption of market-oriented initiatives constantly in progress: amongst the other the opening to acquisition from private and overseas investors, to access controlling stakes in domestic companies (Financial Times, Oct. 9<sup>th</sup>, 2002), and the measures in terms of laws and regulations prepared to encourage Renminbi denominated private equity funds and to allow Sino-foreign joint ventures (FT, Nov. 16<sup>th</sup>, 2007).

Recently President Xi Jinping is undertaking steps to rebalance the economy, maintaining stability while promoting growth, through reforms aimed at opening to private players, banks, and selected strategic sectors such as energy and telecoms, at present still dominated by state-owned giants (Reuters, Aug. 8<sup>th</sup>, 2013).

## **7. From diversification to growth: groups as instruments for product and geographical diversification.**

As articulated by Khanna and Palepu (1997), institutional imperfections in emerging economies can cause market transactions to be more costly and thus strengthen the advantage of diversified business groups. Their empirical study of business groups in Chile suggests that a business group needs to exceed a certain threshold of diversification to benefit sufficiently from its internal market and that such benefit diminishes with the development of the society's institutions (Khanna & Palepu, 1997). The crux of this study is that diversification is a potential growth instrument and thus an antecedent for a business group's better performance, therefore supporting the part of the doctrine that sustains a causal relation, moving from diversification to growth and performance.

The cost-benefit analysis, meanwhile, is expectedly contingent upon the institutional environment in which the firm operates (North 1990).

The most widely adopted theoretical perspective on business groups in emerging economies is the New Institutional Economics. Williamson (1985) suggests that the basic rationale for a diversified firm to earn more rent than a collection of unaffiliated businesses is that the diversified firm, or business group, can mitigate information impactedness in the external market and allocate resources, particularly capital, among its various businesses more efficiently. However, as a firm expands in size and scope, the marginal administrative cost from further expansion will eventually outweigh the marginal benefit, limiting its size and breadth of economic activity; consequently, the advantage of group affiliation will diminish over time (Carney, Shapiro, Tang, 2009).

Diversification is, in developing countries, a paramount strategy to promote the growth of the economy; business groups in general assume different degrees of product and geographical diversification. As maintained in research results collected by Xuqin and Xin (2011), they concluded that a strategy of focused diversification outperforms unrelated or no diversification.

It should be noted that recently strategies to business refocusing have been adopted worldwide because of internal and/or external inefficiencies observed in business groups, both in developed and developing economies. The industrial rationale behind these policies is the main reason for downsizing and re-scaling of the businesses, especially in advanced economies, but other reasons can trigger focusing strategies: exogenous factors like shifts in competition trends, cultural factors, or changes in market institutions.

It is not univocally proven whether or not downsizing, even coupled with acceleration in the privatization process, would achieve better results in developing countries. In particular, in China several factors have indicated that business groups are less likely to refocus their activity; this is because the privatization process is taking place at a gradual pace, groups are powerful and have strong performance, relational norms are emphasized, and business groups are exhibiting a high level of trust in terms of reputational or social capital (Hoskisson, 2005).

The basic idea of the diversification theory has been recently applied to the study of business groups in China, usually combined with other perspectives on product and international diversification (e.g., Li & Wong 2003; Lu & Yao 2006; Ma et al. 2006; Yiu et al. 2005).

The study of international diversification and its effects has assumed particular relevance for China. Chinese geographical business expansion recorded Outward Foreign Direct Investment in 2012 of UDS billion 62.4, marking a year-on-year increase of 45%, while the USA's OFDI for the same period decreased by 19.1 % to 351.4 USD billion (source "FDI in figures", April 2013); business groups account for most of this foreign economic commitment<sup>2</sup>.

These groups' growth has been accelerating since their official birth in the 1980s, with the revenues of the largest 500 groups accounting for 62-69% of China's industrial output in 2004-2006 (Yiu, 2010).

By adopting a multi-theoretic approach, this stream of research finds not only a relationship between diversification and performance, but also direct or moderating influences of diversification strategies and institutional factors on the relationship. For instance, Yiu and colleagues (2005) found that groups with less state ownership or more engaged in acquisition or

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<sup>2</sup> Yiu (2010) reports that in 2003 business groups accounted for 74% of China's OFDI, 63% was contributed by the "national team" alone (namely the first hundred largest groups).

international diversification tend to perform better; it appears that mature groups with higher independence from the initial bureaucracy-centered economic boost enjoy economic advantages when adopting internationalization strategies.

Group affiliation, on the other hand, enables access to a specialized environment able to supply otherwise missing or inaccessible sets of institutional goods and services; this produces the bases for endogenous and exogenous growth in a firm-like ownership, locations, and internalization (OLI) advantages, which in turn generate linkage, leverage and leaning (LLL) opportunities (Yiu, 2009).

Chinese firms' international diversification and expansion often represents a mechanism for the group to gain strategic knowledge and potential and to benefit from different institutional environments, mitigating administrative constraints (e.g. to obtain manufacturing license). This perspective composes the traditional frameworks where OLI and LLL models are considered complementary; with OLI more indicated to explain established incumbents' behaviors, and their aim to grow, exploiting their own advantages, and LLL appropriate in the case of latecomer entrants in a new market looking to enhance opportunities and knowledge.

Chinese business groups mostly achieved the successful geographical diversification pursued by the central planners at the time these strategic organizations were established. Yiu reports that with regard to internationalization performance in 2006, 79.9% of the groups under state administration were profitable and 17.6% lossmaking; 2.5% broke even. According to this study, group affiliation grants to Chinese firms a distinctive local and multinational edge (Yiu, 2010).

On the other hand, Lu and Yao (2006) find product diversification to be more positively related to performance in state-owned groups, and Ma and colleagues (2006) find that affiliation with a business group is more positively related to performance when a firm is state-owned.

Taken together, this stream of research demonstrates not only the potential of the New Institutional Economics approach but also the importance of combining it with other complementary theoretical perspectives in the study of business groups in China. In the meantime, this stream of work so far still does not univocally indicate whether diversification is an antecedent or consequence of performance, given that the better-performing state-owned firms have often been pressured to acquire their poor performing counterparts in related industries and thus become business groups; furthermore, the central government plays a crucial role in licensing and authorizing foreign economic activity to all the economic operators, hence, intervening in their geographical diversification.

## **8. Evolution of China's economic and political institutions: bureaucracy impact factor on business groups**

A more nuanced theoretical analysis should explicitly incorporate the changes in China's economic institutions over time and distinguish Chinese business groups into different types that are differentially affected by the changes in the overall institutional environment. Given the different ways in which they were formed, as summarized above, there are likely to exist three distinct but overlapping populations of business groups in China: the converted wholesale from former industrial bureaus; those that are centered around a private entrepreneur or Ge-ti-hu; and those that developed from successful state-owned enterprises and grew under government guidance and sometimes pressure through acquisition.

It is evident that the impact of state decisions and relations promoted crucial firms' affiliations in the Chinese economic scene, justifying the institutions of business groups not only as a reaction to market voids, but also as a product of the concurrence of political strategies.

The market-voids school of thought maintains that the institutions evolved with the market minimize the importance of political connections, giving space to business groups that initially aggregate to benefit from size and breadth, and are bound to lose momentum when institutions are available. The view based on state-induced affiliation in groups instead sees aggregation as a pretext to bring forward the excellence of a state industrial champion, allowing its performance to positively affect other affiliates.

The analyses based on the market voids presume that the market economy lessens the importance of political relations, suggesting as a likely turnaround point China's accession to the WTO in 2001, when the relevance of *guanxi* is seen as rapidly diminishing to make space to new formal institutions required by global regulations. On the other end, the state role view proposes that the new socioeconomic institutions require a high degree of adaptation from the firms that can continue to benefit from their political connections through new forms of social ties (Haveman et al., 2013).

The economic development process has involved the shift of industrial control from central to a mix of local administration and private hands, including foreign entrants; the emergence of markets to exchange economic and financial goods; and the development to safeguard property rights from the pervading local and international competition (Naughton, 2007). Bureaucrats have influenced in the past the affiliations of firms into groups and still affect their performance through the control they exert upon resources such as land, capital, government contracts and their power to authorize activities and therefore protect markets and

players. In this way the reach of political power does not affect only state-owned or participated firms, but can influence any market operator, public or private.

Remarkably, China in the past 35 years has shifted from a system of state socialism to what has recently been defined as a mix of state-guided and entrepreneurial capitalism; this economic development and the evolution of new institutions have not been reflected in parallel political reforms, with the country displaying little or no change in the political institutions. Because administrative roles remained relatively unaffected by the economic ferment, political connections increased their value for business activity. However, the political, relatively static course has not reflected a similarly static trend in social values: a shift has been observed from traditional values centered on the relevance of community and network connections toward more western individualistic values (Liu and Wang, 2009).

In the past, the role of bureaucrats was mainly allocating and redistributing resources; now state agents act as increasingly powerful economic actors, as regulators or brokers of market transactions. With a developing market and economy, the lack of a parallel reform in the political scene has meant that the relationship network system has acquired new strength because of its strategic role to mediate access to strategic, state-controlled resources, to grant the essential authorizations for opening new businesses, and to guarantee property rights regulations and enforcement. One of the main points of the analyses considered is the empirical support displaying an increasing trend, especially in areas where market development was more remarkable, of the value of political ties over time, and in industries subject to stronger competition; the more competitive an industry is, the higher the level of uncertainty a firm must face, and the more valuable a strong connection is to the bureaucrats. The benefits of political networking also were more effective for smaller dimension firms (Haveman et al., 2013).

Although business groups were not normally pressured by the government to expand internationally, they are also more likely to succeed in international expansion because of their stronger technological and managerial expertise than their peers in China. Some studies did find firms with greater international diversification to be more profitable, but the same cause and effect question also exists in this respect and should be examined with the same theoretical and methodological approach as with regard to the product diversification.

Literature on the above-mentioned types is not exhaustive, nor does it provide a univocal forecast. Since the economic operators that evolved from state-owned companies were particularly susceptible to government pressure to acquire poor-performing companies in related and sometimes unrelated industries, some of the relationships found in extant studies might reflect primarily the diversification-performance relationship in this specific type of groups. In order to ascertain the causality of the relationship, research should satisfy the needs to identify groups of this type as a separate population, collect longitudinal data and use statistical models that can either test causality directly (e.g., Granger regression), control for firm and time effects (e.g., panel data models), or treat acquisition as a selection equation in the model.

Finally, China has undergone rapid economic and institutional changes that may be viewed as exhibiting the pattern of punctuated equilibrium, and these changes have impacted the competitive conditions of different industries in a differential manner. So, it is also important to take into account the competitive conditions in each industry in any analysis of the diversification-performance relationship for business groups in China. This is particularly pronounced for business groups that resulted from the conversion of former industrial bureaus, because one may further categorize groups of this type into two subtypes: those that fall in relatively high-technology industries and have been groomed as national champions, and those



that fall in low-technology industries facing stiff competition from non-state players. In higher-technology industries, the national champions are likely to engage in related diversification to strengthen their market positions, while in highly competitive low-technology industries the still surviving groups may be forced to engage in extensive unrelated diversification. The performance implications of the differing strategies and their interaction with industry conditions can be very different. Indicators of industry conditions include not only the level of technology intensity, but also the relative role of private and/or foreign players in the industry.

## **9. Private sector and groups**

Literature coverage of the gradual development from 1978 of the private sector in China is currently being supplemented, due to the fact that before the reform, particularly after the 1953-56 socialist reconstruction, private property and initiative was considered an ideologically hostile concept and disappeared in China.

The first forms of private business accepted were units that hired less than five employees; hiring more was prohibited until 1988, when new dispositions admitted a broader spectrum of private activity, which was typified mainly by sole ownership, partnership, and limited liability incorporation. Estimates give the number of individual businesses in China in 1988 at 500,000 (Liu, 2003).

The private sector is now relevant in the new political, economic and social asset that China has been assuming since the 1978 reforms, when SOEs accounted for 77.6 % of industrial output: private enterprises have been growing at an accelerated pace, and from the early to mid-1990s, the official private sector has been growing at an average of 35% per year.

In 2006 private enterprises accounted for 37.2% of industrial output, while SOEs decreased to 31.2%. In the same year, foreign-funded enterprises, including Hong Kong and Macau, amounted to 31.6 %, bringing the total weight of the private sector at 65% of gross domestic product; generally, the number of private businesses hardly includes collectively-owned enterprises, such as those owned by cities, urban districts and communities, but individuals and other enterprises. Mild discrepancies were noted on the available statistics' data, probably due to different, non-homogeneous calculation tools; for example, China does not explicitly supply certain indicators, like the private sector output, but the relative data can be evinced residually from the figures provided at national level, corrected and integrated by the state and collective-owned sectors' statistics (He, 2009). According to the Hurun Rich List, China's *Forbes* equivalent source, in 2010 the number of individuals with a personal wealth of at least USD 150mln was 1,363, and "12% of those listed had been appointed to significant government advisory posts", underlying the pervading interlocking connections between economic and political elites, now also at private business level (ten Brink, 2013).

Groups centered around the figure of a private entrepreneur are often considered to have a greedy Ge-ti-hu mentality – easily attracted to quick profit, lacking a coherent strategy and possessing a limited scope of knowledge and learning capacity because they got rich by being highly opportunistic at a time when central planning left many holes in the market for private entrepreneurs to fill. Most preconceptions derive obviously from the nation's socialist, anti "bourgeoisie" ideology, but also from the country's traditional Confucian culture, where entrepreneurial activities were markers of lower status.

Part of the microeconomic doctrine justifies the formations of private groups also as a tool to open to and protect private ownership rights. One of the feared prerogatives of the state,

especially during the first decade of the reforms, was to assume ownership and control over any asset (Ahlstrom et al. 2008). The possible threat of the state challenging private property rights suggested the adoption of defensive strategies for private firms: strategies involved cultivating relations with government officials, taking over poorly performing state-owned enterprises, disguising registering as a collective enterprise the private business as a practice of informal privatization, the so called “wearing a red hat”, or donating services to the local community, in this way promoting again the expansion of the activity of the firm. These strategies were carrying not only the safe recognition from central and local governments, but also valuable practical benefits, such as favorable tax treatments and preferential access to loans and bank credit in general (Estrin, Prevezer, 2010).

The private group’s diversification may be highly susceptible to the capabilities of the dominant entrepreneur, so any examination of the relationship between diversification and performance in this type of groups should take into account the characteristics of the entrepreneur-manager and his or her top management team. Further research can perhaps benefit the upper echelon perspective in traditional strategy research. Here, again, it is important to treat groups of this type as a distinct population.

The modality of the birth and flourishing of a private sector in China witnesses the coexistence of market-oriented entrepreneurial initiative with the pervading role of the centralized and decentralized authority. The two spheres are strictly connected, displaying how the Chinese mixed economy contemplates different concepts of competition and freedom of the actors, due to the interlocking relations in the political, economic and social system, according to the above-mentioned embeddedness of the state in the economic and social life. Therefore the case of private groups also seems crucial for understanding the commixed causal nexus between

diversification and performance and the contribution and intervention of the inter-relationships between bureaucrats and entrepreneurs, although the most recent messages from Chinese and world economic authorities witness openings to a structure prone to the private initiative.

According to the latest projections of the IMF, in 2013 GDP growth in China averaged 7.7% with a low 7.2 for the private sector. Further data on Chinese companies showed Jan. 2014 total registered capital: RMB 96.88 trln (USD 15 trln). SOEs and privately owned enterprises: RMB 84.51 (USD 13.3 trln). Privately owned enterprises: RMB 39.31 (USD 6.2 trln).

In the country notes (p. 123) issued for China by the OECD in 2013 there is the recommendation to "...lower barriers to entry for private firms, for instance, by further reducing state intervention in the private sector and the financial markets and by enhancing the rule of law..." and Zhang Weiyong, former president of the Guanghua School of management of Peking, recently advocated a fast privatization of less efficient SOEs, and confirmed that "many unknown small companies have ultimately become influential international groups through mergers and acquisitions" (People Daily Online, June 8, 2013).

## **10. Concluding remarks**

The aim of this research project is to offer a review of the propositions by recent literature to examine the emergence and success of business groups in China, underlying the causal relationship between product and international diversification, and performance; the review of theories is integrated with empirical studies that adopted longitudinal data, allowing to give a temporal dimension to the development of the relationship.

Available literature indicates a positive correlation between the size and scope of business groups and their performance, confirming also the possibility of the inverse causal nexus in the case of China, based upon the socio-political contingencies at the time of group formation.

Historic social and political contingencies led China to policies promoting firms with successful performances as leaders in the process of affiliation, which consequently resulted in successful business groups, reversing the causal relation between group affiliation and growth, diversification and performance, which for most developing countries is a univocal correlation, moving from size and breadth to higher returns at group level.

As highlighted by the study of Carney (et al., 2009), which focused on the temporal dynamics of business groups, not all the firms benefit from group affiliation, mainly because of the incidence of tunneling behaviors (for example when managers extract resources from companies with low cash-flow rights). Non-univocal evidence is offered about the impact of long-term group affiliation on the single firm's performance, with most of the scholars agreeing on an initial positive impact from affiliation when formal infrastructures are still not available, but with benefits from affiliation diminishing over time, leaving scope for reversing the positive correlation between diversification and performance at the firm's level when the firm considered is not one of the "champions" supported by the government.

Many aspects of the causality nexus between diversification and performance in Chinese business groups still remain unexplored, or just partially or non-empirically researched by existing studies.

Tangible difficulties to obtain a univocal model and forecast are also given by methodologies relying upon the existence and availability of homogeneous, historical sets of data. To give an example of the accounting problems in collecting longitudinal data, there are difficulties to access standard audited data for firms. Also, in the Chinese stock exchange the so called “Special Treatment” companies can be found, namely firms that posted negative earnings for two consecutive years and risk to be delisted.

The methodology also needs refinements to suitably measure the weight of group participation, at present still for simplification purposes, represented through dummy variables, and implying that state policies affect in the same way large and smaller groups.

Further empirical insight should include testing formulated theorizations, given that several complex propositions are still not unanimously accepted, like the negative effect of unrelated diversification or the contextualization of the institutional voids hypothesis; the role of state intervention with the creation of new infrastructures.

The impact of the contribution from the private sector should also be reviewed and tested according to the new role it is adopting, considering the growing weight it is assuming in the economy.

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