Integrated Firms and Business Groups

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Abstract

We study two organizational forms: an integrated (diversified) firm and a business group. The integrated firm itself is one unit. In contrast, the group consists of a parent and subsidiaries and has a hierarchical structure. Since the parent is the subsidiaries' owner but not their manager, there are agency problems; however, the parent is limitedly liable for the debts of the subsidiaries. We characterize the boundaries between the two forms by how risky business is. We show that the group gains more as its business becomes riskier. This property, which we call hierarchical risk-lovingness, is related to the separation of ownership and management and differs from the risk-lovingness in a normal sense. Moreover, it has different implications in internal capital allocation from the normal risk-lovingness. Our model consistently explains empirical findings that have been considered incompatible.

Keywords: integrated firm, business group, limited liability, internal capital allocation
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