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Prerequisites for formation of business groups in separate countries and a Lithuanian case

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Abstract. **In the article business group conceptions of scientists of different countries are analysed; their characteristic general features are discussed; the peculiarities of the formation of business groups are revealed; the heterogeneity of business groups as a phenomenon as well as of its illustrative definition is shown; Business groups in developing and developed countries are reviewed; positive as well as negative operational result of business groups for a country's economic, social, and political life is emphasized. Prerequisites for the appearance of business groups are analyzed; the review of the prerequisites of the appearance of business groups in Lithuania is presented.**

Keywords: **business groups, business diversification, pyramid business structure, "tunneling", market imperfection.**

JEL Classification: **G340, L22**

I. Introduction

During the first two decades of independence, Lithuania, like other post Soviet bloc countries, has experienced a lot of institutional changes due to the conversion of planned economy to a platform for satisfying various social-economic interests by a free demand-supply mechanism. A formation of market relations requires innovative structural transformation of economy, associated with a deep and multifaceted reengineering of economic mechanisms, commercial ideology and inter-firm relations. One of the results of the transformation was the emergence of business groups. These organizational structures denotes a natural transition to a qualitatively higher production organization, management, social responsibility level, further integration of economic and commercial chain, which, unlike the usual individual companies, owns not separate or single but a whole integrated technological cycle, the whole mezzo-economic, sometimes even cross-sectoral conformation of economy, cover the entire production, sales, technical product service and utilization cycles [1, 2]. These hybrid dynamic structures are the object of our research, presented in this paper. Therefore the research problems are the following: what are the reasons for the emergence of business groups?

Do the prerequisites of formation of business groups in Lithuania reflect the prerequisites of formation of business groups, acknowledged in scientific literature, or the post soviet countries have their own peculiarities? The research purpose is to define the reasons for business groups' emergence in Lithuania and other countries. The research tasks are the following: to present a concept of business groups, to define the peculiarities of business groups, to reveal the prerequisites for business group emergence in various countries and Lithuania separately. The following research methods are used: analysis of scientific literature, methods of systematisation and comparison.

II. The concept of business groups

Khanna and Palepu [3] suggest defining business groups as *functional substitutes to fill institutional voids in emerging economies*, other scientists understand business groups as *the product of favourable governmental policies as a way for an emerging economy to close the GDP gap between it and developed economies* [4, 5]. Business groups are *not just a response to market failure or institutional voids in emerging markets, but as vehicles for economic catch-up with more industrialized nations* [6,3]. So a business group is defined as a certain alliance of political capital, created from connections of different power levels with certain businessmen and the big business, arising from the need of emerging economies to even out differences with developed countries [7].

Strachan [8] is one of the first scientists, who acknowledged the existence of business groups and their potential economic influence; he described three main characteristics that distinguished business groups from other similar business organisation forms: *the diversity of activities, the diversity of members, and an atmosphere of trust among members of the group*. As may be seen from the analysis of definitions of business groups it was namely the atmosphere of trust and diversification of activities that became characteristic peculiarities of business groups in separate countries.

Separate scientists distinguish other substantial peculiarities of business groups. Keister [9] presented a modified definition of business groups, according to her it was *"a particular type of intercorporate alliance,"* or business groups were *"coalitions of firms, bound together*

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by varying degrees of legal and social connections more than necessary to perform a short interaction of economic interchange." This is a more precise and corresponding definition of the phenomenon of business groups that emphasizes legal and social connections. According to Khanna and Rivkin [10] a business group is *"a set of firms which are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action."* The statement that appears in this definition about "coordinated action" is an essential peculiarity of business groups because it emphasizes that business groups are created in order to reach certain aims of their owners or founders that, as mentioned further in the article, are not necessarily only a maximisation of profit of business group owners.

In scientific literature current business groups are divided into having vertical and horizontal organisational structures. One characteristic of business groups with a vertical organisational structure is that they are directed towards relations between suppliers and manufacturers, i.e. *collections of firms engaged in supplier-assembler relationships*, and business groups with a horizontal organisational structure are *firms in diversified industries, resembling conglomerates* [11]. So business groups must be analysed not only on certain different geographical and cultural planes but also on different time planes. Seeking to reflect the reality better La Porta [12] emphasizes that business groups must have a pyramid business structure. Such divide between business groups and conglomerates that remain outside the perception of a business group (according to this definition) helps to systematize certain scientists' research of this direction but it does not involve an essential feature of business groups of Southeast Asia and Latin America: all of them are controlled by families

Certain scientists suggest conceptualising business groups as certain *network organisations* [13]. From this point of view it is acknowledged that firms, members of a business group, are legally independent, but are controlled through "inter-firm" connections and act with a certain degree of inter-dependence and coordination [14]. It is even stated that inter-firm connections are more stable than connections among common controlling companies or conglomerates possibly due to an already existing social structure such as a family [15].

When analysing business groups of Southeast Asia the term *family-owned business groups* are often used in scientific literature. Such a term is used seeking to distinguish one feature of business groups of Southeast Asia – all of them are controlled by certain families (usually already by descendants of the second or third generation). Chung [16] presented a definition, very suitable for describing this branch of business groups: *"Family-owned business groups are business subjects of diversified cross-owned firms linked by different factors including a pyramid ownership structure, close market ties* (such as inter-firm transactions) *and linked by family ties through which they coordinate reaching common aims."* It should be mentioned that this definition suits also business groups of Latin America, which makes it quite universal when talking about business groups in emerging markets.

The difference of business group definitions is not accidental. Business groups are very organic formations that are able to adapt to local conditions and that are constantly changing, after all, for example, Chilean business groups are much more diversified than South Korean business groups, which, in turn, are more diversified that groups in Taiwan, and business groups of the Philippines are much more vertically integrated than their Indian analogues and much more involved in the market of financial services than Thai business groups. Finally, in some countries business groups have already become a strong political power, while in other countries relations among business groups and politics are much more strained, and these two encampments keep a certain distance among themselves. Besides, from a conceptual point of view it is possible that this hybrid organisation form between a firm and a market may stimulate new scientific discussions about a firm and its limits [17].

So seeking to reveal the essence of a business group in scientific literature it is possible to state that it is a diversified, quite autocratically managed business organisation form of a pyramid structure, having many branches and subsidiaries, with a controlling shareholder at the top of the pyramid. Separate business groups have specific features. Their certain characteristic attributes in countries of different economic development also have certain national peculiarities

III. Perequisites for the Emergence of Business Groups

In scientific literature three directions of the appearance/growth of business groups are distinguished: *conditioned by organic growth, diversification necessity, and policy-induced.*

Organic growth business groups development based on economies of scale following the logic of vertical integration. Subsidiaries have strong ties with the top of the pyramid, and they use the benefit of the synergy in the areas of personnel management and organisational structure. New greenfield investments are likely, especially when economies of scale are the objective. Advance to other sectors through greenfield investments takes up a lot of time therefore it is likely that subsidiaries belong to business groups for a long time, ties among managers of subsidiaries are dense and close, and personnel rotation between the group firms is frequent.

Diversification-led business groups decrease the risk and increase the profit through risk diversification allowed by corporative management by buying or selling firms. The ability to control risk stimulates managers to advance to less stable market industries or countries. Business groups of this type are more inclined to buy firms than create them from scratch and also to dispose of firms that start failing without hesitation instead of investing additional capital for reaching their purpose. Since business groups of this type often buy unrelated firms, the level of technological interchange inside the group is quite low, and group owners are inclined to delegate more management rights to companies of controlled firms especially in developed markets, granting them quite an expressed autonomy. Diversification of a wide profile also has some disadvantages especially related to information asymmetry, which could evoke great losses in emerging markets, where access to information is one of the competitive advantages of business groups.

Policy-induced business groups appeared as a reaction to governmental initiatives or directives. The appearance roots for policy-induced business groups are very similar – they were used as an instrument to implement governmental objectives – performing the process of changing import by industrialisation in Latin America [18], stimulating economic growth oriented towards export in East Asia [19], for the creation of social democracy in Sweden [20], and for autonomous implementation of defence contracts in Israel [21]. So it is natural that they cannot be separated from politics, but, as may be seen from the research of this area, some time ago politics used to use their influence for business groups, while the situation has now changed in favour of business groups [22]. And although economists do not like to talk about political influence, such discussion is inevitable when analysing business groups. Pyramid business groups concentrate in themselves a very big economic power, which may be imperceptible at first. For example, big business groups are especially prevalent in Russia, where they have coalesced with the political power so much that it is very difficult to separate the limits between business groups and the country's institutions. Other political advantages of business groups when compared with separate firms may appear from the mentioned family control. One of them is the fact that family members may form much longer political agreements than employed managers. Besides, business groups have a better possibility to acquire and control economic and political information especially using a privileged access to the process of policy formation [22]. Participation of the government in the stage of initial formation and development of business groups is assessed as an essential factor that created the conditions for their flourishing in emerging economies [23]. There are even more scientists, who state that business groups are a result of state policy (not necessarily a successful one). Guillen [24] states that business groups were created as a state instrument seeking for political and economic aims. Close ties of business groups with governments provided business groups with political capital and other politically oriented resources that were not available for independent local firms [4, 5, 25]. Guillen [24] even rates governmental protections as an essential prerequisite of appearance of business groups of all types. Researches of Zhu and Chung [26] confirm that political ties have an essential and positive influence on business groups when they advance to different industries. Firstly, it is related to the access to confidential information, accessibility of resources, preferences of political power for certain business groups, which provides certain legitimacy of actions. In the research of these scientists a fact may be seen that it is more difficult for business groups to leave the business areas where they have acquired strong positions although it becomes evident that the areas are not promising anymore, and these business groups still direct a part of their resources into these areas for a long time, while small and medium sized enterprises, according to Chung and Mahmood [15], are more flexible with regard to the change of business direction. Following this thought it is possible to make an assumption that business groups are not such efficient market subjects as small and medium sized enterprises, and the ability of business groups to redistribute resources adequately cannot be assessed just in a positive way. A certain merging of business groups with a country's political government happens also due to other reasons – uncertainty regarding property protection. As mentioned before business groups were formed in countries with imperfect market structures, undeveloped institutions, and incompetent/corrupted legal systems; and an authoritarian management model is often evident in such countries (South Korea until 1987, Indonesia, governed by General Suharto, Pinochet's authoritarianism in Chile, Thailand, governed by military juntas, etc.), where profit maximisation may become vacuous in the long run due to possible confiscation/nationalisation of property (shown by events in Russia) or other disregard of interests of legal owners. Business groups see cooperation with state institutions, partial performance of their policy receiving additional allowances/concessions and preferential conditions for state orders, exploitation of state property, performance of monopoly functions, etc. as one of possible ways of insurance against such actions. This serves also as additional barriers for the coming of competitors, and this also strengthens the monopoly or oligopoly position of the business group with regard to a certain industry. So in this case the decrease of political risk using the method of convergence with political leadership creates additional profit possibilities for business groups and helps to ensure their dominating positions.

Not only supporters of political economy or transaction costs and institutional economics have analysed the reasons for the appearance of business groups. The attitude on the emergence of business groups suggested by economics sociology is also very interesting. Economics sociology analyzes, among others, how social and cultural models form organisations of various types. An assumption is made that firms are isomorphic formations surrounded by social structures, and business groups are the result of horizontal, vertical, and mutual ties among social structures and firms. Economics sociologists, analysing East Asian countries, found that business groups, controlled by one person, were more prevalent in countries of vertical social connections (Korea) but were rare in countries of mutual (Japan) or horizontal (Taiwan) connections [27].

It is possible to state that in countries with a developed financial sector, open economics, and well operating supervision institutions business groups do not acquire any significant advantages when compared with other market participants [28]. The authors state that operation of business groups in a certain country directly indicates drawbacks of market environments of these countries, and the part of economics controlled by business groups may be an index of institutional drawbacks of the country's economics, but at the same time it raises a scientific questions why powerful business groups are so successful in such a developed country as Israel with such an advanced financial system, a mature market, and strong and independent supervision institutions? Seeking to fill this gap of scientific literature and based on the research of Israeli economics performed by Aharoni [29] an assumption may be made that the fact that business groups that form in Israel are almost analogous to business groups of Southeast Asian countries from the point of view of their structure and genesis allows to state that business groups are not only a product of market imperfections but also a reflection of certain social systems in business. After all Zionism and Confucianism are quite close religious/philosophical directions from the point of view of sociology that form quite a similar world outlook on business of social members that follow these directions. Another bright similarity of business groups in Israel and South Korea is that for the most part they were formed to solve state economic/political objectives, in other words, business groups of Israel and South Korea are a certain outcome of a symbiosis of politics and the market.

So although from the point of view of political economics the coalition of business and the state seeking for objectives of both partners is named as a reason for emergence of business groups, but the imperfection of the market, its mechanisms, and controlling institutions should also be assessed as a reason for appearance of business groups at in least in some developing countries or countries of emerging economies. In other words, business groups may overcome market disproportions and drawbacks and institutional imperfections of developing countries, taking on the functions of a country's human capital, financial resources, and the market of intermediate products.

IV. A REVIEW OF REASONS OF EMERGENCE OF BUSINESS GROUPS IN LITHUANIA

Companies of the so-called "union importance" that dominated the Lithuanian economy during the command-planned doctrine were big scientific-industrial complexes encompassing production manufacture as well as scientific-research works, logistics, employee training, qualification training and employee recreation centres, also they had separate secret departments for military use. When passing to market economy relations the programme of privatisation by cheques performed by the country's government enabled interested people to buy all these mezzo-economic formations with even their secret pertinents (scientific-production complexes for military use "pochtovyje jashchiki") at a price considerably lower that their real market value. Under conditions of the free market such formations just cannot function due to inefficient resource allocation, a lack of transparency of financial accountability, and a very ineffective organisational structure, created, in fact, for the needs of a military complex. When reorganising such companies into competitive economic / economical structures their activities had to be optimised by separating departments of logistics, product creation (design), employee recreation centres, and other structural compounds not necessary for the main activities into separate individual companies; their shares were managed by the main company, thus creating the first business groups in Lithuania (AB "Ekranas", AB "Mažeikių nafta", etc.). Orders, necessary to ensure efficient activities of the parent company, determined successful activities of subsidiaries that met the demands of the parent company, and the cover of fixed costs by orders of the parent company created a possibility to provide services of competitive prices to external customers thus increasing their market share. Eventually subsidiaries of the business group, having established a reputation in the market and having extended the ring of their external clients, were able to transfer their fixed costs to external clients, and this enabled them to decrease the prices of their services/production for the parent company, thus increasing its competitiveness in the market and contributing to the growth of common competitiveness of the business group as an integral business subject.

Most often in countries of developed markets there are business groups led by diversification. These business groups were established a bit later than the above-mentioned business groups that appeared under conditions of privatisation. The beginning of a more pronounced growth of such type of business groups was in 1998-2000 (although their rudiments were seen much earlier, in 1993-1994), when companies, affected by the results of the Russian crisis, having lost a bigger part of their export markets, decided not to concentrate on the increase of the capacities of their main activities that have long before passed the limits of the inner market, but directed most of their financial, intellectual, and human resources to other areas that were new to them. Seeking not to risk financial indices and the reputation of the main company that would inevitably suffer if the new economic-commercial or financial activities did not succeed, companies started to establish subsidiaries for the development of new activities. Executives and shareholders of the controlling companies became heads of these new companies. Due to a quite conservative continental-type financial sector in Lithuania the only reachable capital market for the newly established companies that did not have a successful history of activities was the inner capital market of the business group ("Panevėžio keliai", "Alterna grupė", "Gridins group", "SBA"). The use of diversification of activities as an engine for growth can be most clearly seen in the Lithuanian trade sector. The biggest Lithuanian business groups "VP Grupė" and "MG Baltic" were born from this sector. The first one expanded its activities also into areas of real estate management, security, financial mediation, food production, services of alimentation, while the second one went into the sectors of real estate, alcoholic beverages, production of biofuel, logistics, mass media, and construction. The growth of these business groups is firstly related to the entrepreneurship of their leaders, and proper and timely rotation of executives that enable them to pass their knowledge and skills to employees of other companies of the group. This is especially clearly seen in the group "VP grupė" –its inner employee market can be considered to be especially efficient because not only executives but also employees and specialists of the middle level have a possibility for vertical as well as horizontal career, possibilities for train and development in new companies of the group and new areas.

The country's governmental institutions' aim to make Lithuania a country of knowledge economy can also be considered a certain prerequisite for the stimulation of the formation of business groups in Lithuania [30]. Academic literature states that in order for new knowledge to become a country's comparative advantage it is necessary for the country's industry and service sector to be very differentiated [31]. This condition forced the country's government to stimulate the appearance of new economic / economical activities in the country especially in the field of high technology. Taking advantage of exceptions of state institutions and access to the inner capital and human resources markets some companies / company groups took this possibility to widen and differentiate their activities even more and to add additional types of activities to their portfolio ("BOD group", "Eksma" group).

Patronage and decisions of state institutions when reorganising the structure of the country's economy determined another prerequisite of formation of business groups that was especially evident in the sector of energy. The energy sector is considered to be strategically important for the country's national safety [32]. This determined that in this sector there is an aim to retain the dominating position of the state in the structure of shareholders and management bodies. Seeking to reach this aim but wanting to attract also some external capital necessary in order to modernise this sector that is especially sensitive to investments, the classical pyramid structure of business groups and even a partial "tunnelling" effect model were used. At the top of the pyramid of the Lithuanian energy sector there is the Ministry of Energy (later, seeking to ensure the compliance with the requirements of the 3rd Energy Legislative Package of the EU, the Ministry of Economy) that manages the dominating block of shares in all companies (AB "Lietuvos Energija", AB "Visagino Atominė Elektrinė", AB "Ignalinos Atominė Elektrinė", AB "Lesto", AB "Litgrid"), but some shares (as a means to attract investments) are left to small shareholders, who do not have any influence on the management of these companies or decisions of capital disposition due to their part of shares being very small, so they are just financial investors. The Lithuanian electrical energy sector has also other features of business groups: inner rotation of executives, a dominating position in the market, a big number of subsidiaries (UAB "Energijos tiekimas", UAB "Baltpool", UAB "Technologijų ir inovacijų centras", UAB "Data logistics center", VšĮ "Respublikinis energetikų mokymo centras", UAB "NT Valdos", UAB "Tetas", UAB "Kauno energetikos remontas", UAB "Geoterma", etc.), and internal inter-transactions. There are more business groups in the Lithuanian energy sector: "Scaent Baltic", "Fortum Heat Lietuva", etc.

Some companies evolve into business groups seeking to manage the whole technological cycle of product production and realisation from the creation of raw materials for production to the presentation of products to consumers, thus optimising their cost structure because centralized management of the supply chain creates value for all participants of the chain. AB "Kauno grūdai" group, "Agrokoncerno grupė", "Litagros grupė", "Libros grupė", "Vakarų medienos grupė", and "Plasteksus" group may be considered to be such business groups in Lithuania. In the service sector the "Limarko" group is seeking to encompass the whole inter-branch economic complex.

Another prerequisite for the formation of Lithuanian business groups is the use of accumulated knowledge, experience, and know-how for the development of activities analogous to the company's (company group's) activities abroad. The development is both to the East as well as to the West; internal company capital resources are actively used for the funding of new activities; often the best company specialists (especially from the management area) are sent for a certain period of time for missions to the countries where activities are developed. Such combination of internal capital of business groups and work force markets in foreign countries assisted the creation of such business groups as "Litana grupė" and "Tiltra Group".

Some Lithuanian business groups formed having acquired a monopoly in the area of the provision of public utilities in a certain region. The provision of monopoly services guaranteed stable financial flows, weakly affected by market tendencies, and a stable and forecasted profit for companies. This comfortable situation allowed performing a wider diversification through acquisitions and establishment of new companies using financial resources of external capital markets. They were easy to reach also because banks were looking for safer areas to use free financial capital that suddenly appeared after the Lithuanian business was shaken by the Russian crisis that was accompanied by a big wave of company bankruptcies. Considering the sector of public utilities and public welfare provision to be very safe, financial investors lent capital flows necessary for the development of business groups for a smaller risk premium than it was accepted in the market. Acting in a quite close monopolised area, necessary for ensuring welfare of the society, companies acquired the favour of certain state institutions and persons, and it also enabled them to start new businesses that were partly related to their main activities or parallel to their main activities, also limited by high barriers of market access, thus additional economic sectors of the country were also oligopolised. Some of the best examples of such business groups are “ICOR Group” (70 companies in the fields of public utilities, industry, energy, design, mechanical engineering, biofuel production, real estate management, event organisation, etc.) and “E Energija”group (energy production, construction, public utilities, mechanical engineering, design, etc.).

In the sector of food production also a deeper integration of companies may be noticed that in the long-run caused the formation of business groups. There are 2 business groups in the Lithuanian milk and milk product production sector, oligopolised by 4 big business subjects: AB “Žemaitijos Pienas” (4 companies), AB “Rokiškio sūris” (6 companies); other enterprises chose another organisational structure – they incorporated affiliated companies into the main company as branches, so, although in many ways they correspond to criteria of business groups, they cannot be considered as such.

Nevertheless the biggest Lithuanian business groups were formed and grew strong with the help of many prerequisites, and they cannot be attributed to one prerequisite for the formation of business groups distinguished in theory. The big Lithuanian groups formed using undeveloped finance, capital and work force markets as well as imperfect state institutions and structural deformations of the Lithuanian economy during the passing from planned economy to market economy, as well as very good political connections for receiving state concessions / preferences.

V. CONCLUSIONS

Politics, dictated by state institutions, businessmen, and competitive and institutional environments play an important role for the formation of evolutionary roads and competitive strategies of business groups. Business groups, as a bigger part of any economic subjects, have positive as well as negative sides. Business groups may be viewed as certain organisational structures, which may be used to overcome certain market drawbacks and imperfections seeking to create global-level conglomerates in countries of emerging economics. From the other side, certain transactions inside a group and a lack of transparency and accountability allow business groups to further enjoy the advantages provided by sometimes not very transparent relationships and acquaintances seeking for the distribution of beneficial resources as well as restriction of the rights of small shareholders.

Concentration of too much capital in the hands of certain business groups and their domination in a country’s economics may aggravate the creation of small and medium sized enterprises and their operations in local and even international markets, which may be dangerous on the state scale, because small and medium sized enterprises are considered to be the ones that adapt to changing economic conditions more easily. Nevertheless, scientist have proved that business groups show better results than separate firms, so on the state scale they are a phenomenon that is more desirable than avoided, because GDP of a country where suitably operating big business groups are present increases faster then GDP of those countries, where this phenomenon is not widespread, so probably scientific discussions and scientific research regarding the direction of economics and business of developing countries should be directed towards the problem of how to minimize drawbacks of a country’s economic/political/social life caused by business groups and how to strengthen advantages provided by them, and not to discuss the question if business groups as an institution are useful for economics of emerging markets.

Lithuanian business groups formed using prerequisites revealed in scientific literature as well as other ones, characteristic only of economies of Lithuania and other post-Soviet countries that remained in the shadow of scientific interests of scientists, who research / researched business groups. The further analysis of such uncommon to Western world economical structures like privatisation induced business groups could reveal new insights in institutional and especially neoclassical economics and its structure – conduct – performance paradigm stating, that firms integrate verticaly and horizontaly in response to market power of other economic agents. The role of such business groups on formation of structural and institutional voids in post-soviet economies should be examined deeply.

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