A series of recent research papers have examined the potential reasons for firms to become affiliated with groups, but conclusive evidence establishing the principal source of their formation has not yet been established.[9] Most explanations center on how groups affect corporate governance and the intra-group allocation of financial resources. Groups allow for the separation between ownership and control in an economy with thin equity markets. Another key reason that groups may exist is that they allow the formation of internal capital markets. When the financial system is not well developed and potential sources of funds for expansion are expensive or scarce, internal capital markets can reduce the severity of financing constraints. Parent firms can direct intra-group transfers of funds to a constrained member firm. In addition, large parent companies or group member firms that specialize as liasons with domestic or international banks might gain access to funds at a lower cost than a constrained member firm acting alone.

Group membership may also lead to incentive problems between controlling and minority shareholders that have the potential to lead to value-destroying investments. Controlling shareholders in the parent firm can expropriate minority shareholders' wealth in several ways. The controlling firm can set artificially low transfer prices for intermediate materials the parent company uses as inputs, increasing cash flow in the parent firm (where the controlling family's stake might be proportionally much higher). Controlling shareholders might also direct group funds toward member firms with poor investment opportunities, but whose business activities provide the controlling shareholder with non-pecuniary benefits. Groups also minimize the bankruptcy risk for the controlling shareholder on top of the pyramid when the affiliated firm undertakes risky projects.

3. The link between finance, investment, and Italian corporate governance

The financing constraint literature focuses on the relationship between a firm's financial strength and its ability to gain access to funds to use for investment. A central proposition of the this literature is that imperfections in capital markets create a wedge between the cost of internal and external finance. Recent research argues that the principal source of the wedge may be due to asymmetric information between firms and potential suppliers of external finance. This wedge might be particularly high not only for Italian firms, but firms in many other continental European countries where equity markets are poorly developed and few alternatives to bank finance exist.

[9] See Brioschi, Buzzacchi, Colombo (1989), Barca (1996), and Bianchi, Bianco, Enriques (1999).