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Working Paper

Mis-Allocation within Firms: Internal Finance and International Trade

CESifo Working Paper, No. 9426

Provided in Cooperation with:

Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Doerr, Sebastian; Marin, Dalia; Suverato, Davide; Verdier, Thierry; Verdier, Thierry (2021) : Mis-Allocation within Firms: Internal Finance and International Trade, CESifo Working Paper, No. 9426, Center for Economic Studies and ifo Institute (CESifo), Munich

This Version is available at:

<https://hdl.handle.net/10419/248971>

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Impressum:

CESifo Working Papers

ISSN 2364-1428 (electronic version)

Publisher and distributor: Munich Society for the Promotion of Economic Research - CESifo GmbH

The international platform of Ludwigs-Maximilians University's Center for Economic Studies and the ifo Institute

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Editor: Clemens Fuest

<https://www.cesifo.org/en/wp>

An electronic version of the paper may be downloaded

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Mis-Allocation within Firms: Internal Finance and International Trade

Abstract

This paper develops a novel theory of capital mis-allocation within firms that stems from managers' empire building and informational frictions within the organization. Introducing an internal capital market into a two-factor model of multi-segment firms, we show that international competition imposes discipline on managers and reduces capital mis-allocation across divisions, thereby lowering the conglomerate discount. The theory can explain why exporters exhibit a lower conglomerate discount than non-exporters (a new fact we establish). Testing the model's predictions with data on US companies, results suggest that Chinese import competition significantly reduces managers' over-reporting of costs and improves the allocation of capital within firms.

JEL-Codes: F120, G300, L220, D230.

Keywords: multi-product firms, trade and organization, internal capital markets, conglomerate discount, China shock.

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1st October, 2021

We would like to thank Paola Conconi, Elhanan Helpman, Veronica Rappoport, Claudia Steinwender, and Adam Szeidl for helpful comments and suggestions, and Philipp Herkenhoff for excellent research assistance. We also thank participants in seminars at the London School of Economics, Bocconi University, the University of Hong Kong, the New Economic School Moscow, the CEPR European Research Workshop in International Trade, Virtual World Congress of the International Economic Organization, and CESifo Area Conference on the Global Economy for valuable comments. The authors gratefully acknowledge financial support from the German Science Foundation (DFG) for grants No. MA-1823/5-1 and MA-1823/5-2. The views expressed here are those of the authors only, and are not necessarily those of the Bank for International Settlements.

1 Introduction

A well-established observation in the trade literature is that conglomerate firms are more productive than single-product firms and dominate in international trade and manufacturing sales. They account for two-thirds of exporters, 98% of export value, and 91% of US manufacturing sales (Schoar, 2002; Bernard et al., 2018). These facts appear to be at odds with findings in the finance literature: multi-segment firms trade at a discount and have lower Tobin's Q than single-product firms (Lang and Stulz, 1994; Ozbas and Scharfstein, 2010), because internal capital markets mis-allocate funds across divisions within firms (Rajan et al., 2000; Scharfstein and Stein, 2000).

In this paper, we reconcile these two conflicting views by embedding an internal capital market into a model of multi-product firms with monopolistic competition. In the model, managers of multi-product firms compete for funds within their firms. However, the headquarters does not know the true marginal costs of its divisions, while the divisional managers do. This informational friction allows managers to run bigger divisions by over-reporting actual marginal costs to receive more capital. Importantly, managers in better divisions have greater scope for mis-reporting, as they are less at risk of not being financed. This results in a distorted allocation of capital across divisions: headquarters over-allocate capital to some divisions, which reduces firms' return on assets and depresses Tobin's Q , resulting in a conglomerate discount.

We then introduce competition through international trade into the model and investigate how it affects the allocation of capital within firms. Competition lowers the cost level at which firms and their divisions can survive in the market. Because managers use this cut-off cost level as a benchmark when deciding by how much to mis-report costs, competition has a disciplining effect and reduces their scope for over-reporting. The model thus predicts that competition leads to a re-allocation of capital within multi-segment firms towards better segments, thereby increasing firms' profitability and Q , hence reducing the conglomerate discount.

We confirm these key predictions in the data. By exploiting exogenous variation in import penetration from China at the sector level as a shock to competition, we show that the conglomerate discount declines more among firms in industries that are subject to a stronger increase in competition. Tougher competition also leads to a significant decline in marginal costs and a rise in allocated capital among the best segments, in line with the model's predictions. Importantly, these effects are stronger among firms subject

to higher internal informational frictions.

Traditional models of multi-segment firms in the trade literature predict that project funding goes to the most productive segments and that all projects with positive profits are financed.¹ However, an internal capital market within an organisation is subject to informational frictions – it may not always allocate resources efficiently and it may not fund all projects with positive returns. To understand the type of products that firms finance, produce, and export, it is essential to examine the internal allocation of funds. This requires a theory of multi-segment firms that is micro-founded in an organisational theory of corporate finance. Our paper provides a first step towards such a theory.²

To model the internal capital market we combine the concepts of “winner picking” (Stein, 1997) and “over-investment” (Rajan et al., 2000; Scharfstein and Stein, 2000). The former implies that headquarters rank segments by their return on assets and allocate more capital to the best-ranked segment. However, over-investment can arise because the headquarters knows less about a segment’s true cost than its divisional managers.

We incorporate an internal capital market with these features into a two-factor version of the Mayer et al. (2014) monopolistic competition model of multi-product firms. In our model, divisional managers compete for funds allocated by the headquarters, subject to an informational asymmetry between the headquarters and divisional managers of firms. To allocate funds to the firm’s various divisions, the headquarters ranks divisions relative to one another by their return (winner picking). However, the headquarters has inferior knowledge about the true costs of divisions. This information asymmetry allows firms’ divisional managers, who have an appetite for running bigger divisions (i.e. they are empire-builders), to not report their costs truthfully. Instead, divisions over-report their costs and end up receiving more capital than optimal.

We show that the resulting mis-allocation of capital within firms leads to the emergence of a conglomerate discount. Specifically, a distinct prediction of our model is that a firm’s Q decreases with its average marginal cost, and increases with the dispersion in marginal costs across segments. Intuitively, more severe frictions increase average marginal costs, because managers over-report their costs to get more funding, reducing

¹See, for example, Bernard et al. (2010); Eckel and Neary (2010); Dhingra (2013); Mayer et al. (2014); Nocke and Yeaple (2014).

²Internal capital markets represent an important source of funding in US publicly listed firms. Internal cash flow accounts for 83% of total funds in multi-segment firms. While it is equally important for exporters (80%), cash flow matters less in single-segment firms (30%); see also Marin and Schnitzer (2011).

efficiency. Additionally, mis-allocation reduces dispersion in marginal costs across segments, because the relatively more pronounced over-reporting at better segments moves their costs closer to those of the worse segments. We find strong empirical support for this relationship among a sample of US companies: an increase in average marginal costs (their standard deviation) significantly decreases (increases) firms' Q , even among firms within the same industry.

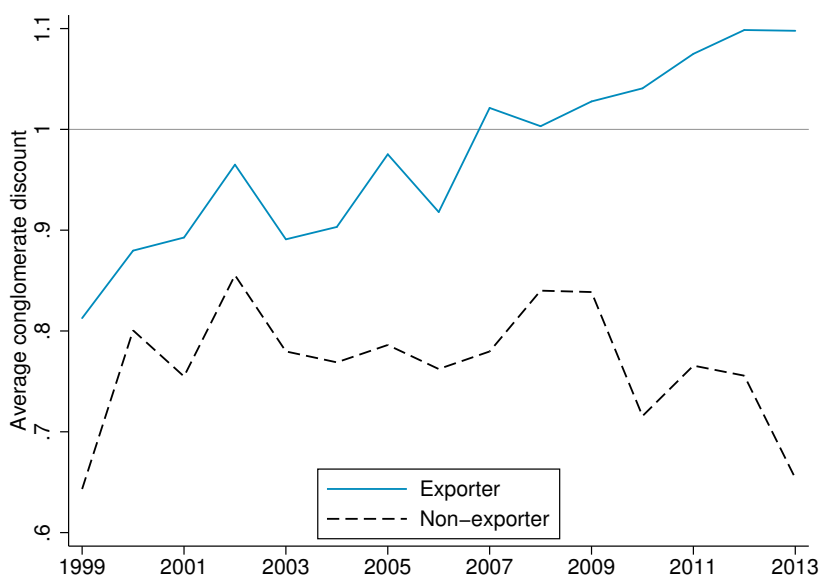
In addition, we empirically show that multi-segment firms allocate more capital to segments than single-segment firms with similar marginal costs. This relation follows directly from the model: mis-allocation within multi-segment firms arises from segment managers' ability to over-report costs due to informational frictions between the headquarters and managers. As there is no such incentive conflict in single-segment firms, the model predicts that multi-segment firms over-allocate capital to segments, relative to single-segment firms with comparable costs.

A further prediction of the model is that the relationship between marginal costs of a segment and its allocated capital follows an inverse U-shape. The inverse U-shape arises from opposing forces. On the one hand, segments with higher marginal costs require more capital and managers over-report the true cost of their divisions to receive more funding. Both effects lead firms to allocate more capital to a segment when marginal costs rise. On the other hand, segments with higher marginal costs must charge higher prices and hence face lower demand, and managers of segments with high marginal costs face a higher probability of not being funded at all, which limits over-reporting. With rising marginal costs, the latter effects start to dominate, so the positive association between marginal costs and asset allocation reverses. The data reveal such a hump-shaped pattern: capital allocated to a segment increases for lower values of marginal costs, but declines for higher values.

We then theoretically and empirically investigate the effects of competition on firms' internal capital markets. One novel empirical fact we establish is that exporters suffer from a lower conglomerate discount than domestic firms. Figure 1 plots the ratio of average Q of multi-segment firms over average Q of single-segment firms (the conglomerate discount) for each year in our sample. We split the sample into exporting (blue-solid line) and non-exporting (black-dashed line) firms. Our first observation is that multi-segment firms have lower Tobin's Q than single-segment firms. For both exporting and non-exporting firms, relative Q is below unity on average. The difference in Q represents the well-known conglomerate discount. The second observation is that the conglomerate

discount is smaller for exporting firms: the blue-solid line for exporters lies above the black-dashed line for non-exporters in every year. Furthermore, the discount remains stable for non-exporters but declines over time for exporters (higher values on the y-axis denote a narrowing in the difference in Q between single- and multi-segment firms). For the years following the financial crisis of 2007–08, the ratio surpasses 1 and the discount turns into a premium.³ Exporters’ lower conglomerate discount suggests that firms exposed to open markets differ from domestically active conglomerates.

Figure 1: Conglomerate discount over time – by exporter status



Note: This Figure plots the ratio of average Q of multi-segment firms over average Q of single-segment firms (the conglomerate discount) for each year in our sample. We split the sample into exporting (blue solid line) and non-exporting (black dashed line) firms. The patterns are robust to the accounting for firm characteristics, as well as time-varying trends at the industry level (unreported). Data are from Worldscope.

By taking the interplay between internal capital markets and external competition, modelled as a shock to the costs of international trade, into account, we open the black-box of multi-product firms, which allows us to explain these novel empirical patterns. The key insight that we gain from introducing an internal capital market into the theory of multi-product firms is that our model shows how mis-allocation of capital within firms is affected by international trade: a more open trade environment, which is synonymous

³Pooling our sample across years, the average multi-segment firm has a 16% lower Q than a single-segment firm. The difference in Q averages 25% for non-exporters and 12% for exporters and narrows over time (unreported).

with a more competitive market, improves the efficiency of the internal capital market. Tougher competition lowers the cost level at which firms and their divisions can survive in the market. Managers use this cut-off cost level as a benchmark when deciding by how much to over-report costs when they ask for funds from the headquarters, as they run a risk of not being financed if costs are too high.

The model hence predicts that tougher competition leaves less room for over-reporting and thereby reduces segments' marginal costs. This in turn reduces the conglomerate discount. In particular, marginal costs fall (and assets increase) relatively more in the best segments, where managers' scope for over-reporting of costs declines the most (i.e., in those segments with the largest initial over-reporting). The fall in marginal costs in the best segments relative to worse segments implies an increase in dispersion of marginal costs across segments and a fall in the conglomerate discount.

For the empirical analysis we derive a set of key predictions from the model. Specifically, tougher competition leads to *i*) a fall in relative marginal costs and *ii*) an increase in allocated assets among the best segments, relative to worse segments of multi-segment firms; and *iii*) the induced fall in marginal costs and increase in allocated assets imply that competition reduces the conglomerate discount. To test these predictions, we exploit the increase in import penetration from China – the China shock – as a source of exogenous variation in industry-level competition. Following (Autor et al., 2013), we instrument US imports from China with Chinese imports in eight other advanced economies. Using detailed data on public US manufacturing firms at the segment level from 1999–2007, provided by Compustat, we test the derived relationships between competition, marginal costs, assets, and the conglomerate discount derived from the model.

We first show that the conglomerate discount significantly declines when competition increases. We find that a one standard deviation increase in import penetration in a given industry lowers the average conglomerate discount by around one-third over the sample period.

To shed light on the underlying channels, we then investigate how competition affects segment marginal costs and the allocation of assets across segments. As predicted by our model, we find a significant decrease in marginal costs as well as an increase in allocated assets among the best segments in response to higher competition, relative to worse segments. The underlying friction that gives rise to mis-allocation is asymmetric information. We thus expect the disciplining effects of import competition on segment

marginal costs and assets to be particularly strong within firms that suffer more from informational asymmetries. To this end, we use data on CEO backgrounds to classify firms into those with high and low informational frictions. We categorise firms by the time their average CEO spent on the board. The longer the time a CEO has served on the board of a company, the more likely she is to know its segments and the lower the scope for over-reporting. We also split firms along the average number of boards a CEO sits on, building on the argument that CEOs that sit on the boards of many firms have less knowledge about firms' individual segments. We find the disciplining effects of competition (i.e., a decrease in marginal costs and increase in allocated assets to the best segments) to be particularly strong in firms subject to higher informational frictions.

In terms of magnitude, a one percentage point increase in import penetration leads to a relative decline in marginal costs of better segments by 5.9%. The same increase in imports increases assets allocated to the best segments by around 18%. Based on our model, we can use these estimates to infer the change in divisional managers' over-reporting factor in response to fiercer competition. For a one percentage point increase in imports the over-reporting factor declines by a relative 15.9% in the best segments. Taken together, our empirical results provide strong support for our main predictions. They suggest that competition causally improves the allocation of capital within multi-segment firms and reduces the conglomerate discount.

We perform additional tests to rule out alternative explanations. First, we directly control for the cost of (external) capital, as declining interest rates have been linked to capital mis-allocation (Gopinath et al., 2017). Our main findings remain unaffected when we account for the effects of changes in industry-level financing costs, proxied by the average interest expense over total debt for each industry. Second, our model suggests that firms' marginal costs decline in response to tougher competition because it disciplines managers. Yet, firms could also be investing in cost reducing innovation in response to more competition. We address this concern through a placebo exercise: As single-segment firms are not subject to internal informational frictions that enable over-reporting, competition should have no effect on marginal costs through its effect on over-reporting. Yet, if there is cost-cutting innovation, marginal costs should decline also among single-segment firms that are exposed to competition. Results show that changes in Chinese imports do not affect marginal costs in single-segment firms significantly. This finding provides support for our mechanism that rising competition reduces marginal costs among multi-segment firms by reducing managers' scope for over-reporting.

Our paper contributes to the literature in corporate finance that analyses firms' internal capital markets. In particular, we provide a novel link between external competition and internal capital allocation. In a seminal paper, Stein (1997) argues that the internal capital market can allocate capital more efficiently than the external market. In contrast, Scharfstein and Stein (2000) show that the internal capital market can be inefficient: managers of weak divisions are willing to spend more time trying to convince headquarters to get a larger capital budget, and multi-segments firms can hence suffer from a conglomerate discount. More recent literature in corporate finance questions whether a conglomerate discount exists in multi-product firms (Maksimovic and Phillips, 2013). Our paper adds to this debate by showing that whether a conglomerate discount or premium occurs depends on the competitive environment a firm faces. For example, exporting firms may face a conglomerate premium (see Figure 1) as their internal capital market is disciplined by international competition.⁴

We also speak to the literature in international trade. Workhorse models in the spirit of Mayer et al. (2014), including Bernard et al. (2010, 2011), Eckel and Neary (2010) and Dhingra (2013), mostly abstract from financial issues. By micro-founding the theory of multi-product firms in a finance theory of organisation, we endogenously generate heterogeneity in firms' cost structure, which is typically exogenous in the literature of multi-segment firms.⁵ A distinct feature of our model is that the cost structure of a firm depends on its internal organisation.

Finally, our paper relates to literature on capital mis-allocation (Hsieh and Klenow, 2009).⁶ Several papers identify financial constraints as a reason why the marginal products of capital are not equated across firms (Banerjee and Moll, 2010; Caselli and Gennaioli, 2013; Gopinath et al., 2017). These papers focus on inefficient allocation of resources across firms and show that mis-allocation is an important factor explaining differences in productivity across countries. However, Kehrig and Vincent (2020) establish that a sizeable share of overall mis-allocation occurs *within*, rather than between, firms. In our paper, mis-allocation of capital within firms arises due to an information asymmetry between headquarters and managers. Importantly, mis-allocation within firms arises even in the absence of mis-allocation of capital across firms. We further provide a novel

⁴For reviews of the literature on internal capital markets, see Stein (2003); Maksimovic and Phillips (2013) and Mueller (2016).

⁵For an exception, see the literature that introduces organisations into trade models, which shows that firms reorganise to a more decentralised organisation in a more competitive trade environment (Marin and Verdier, 2008, 2012, 2014; Caliendo and Rossi-Hansberg, 2012).

⁶See Hopenhayn (2014) and Restuccia and Rogerson (2017) for surveys.

channel that links the level of market competition to within-firm capital allocation.

The rest of this paper is organised as follows. Sections 2 to 4 present the model. Section 5 derives testable predictions and then takes the model to the data: exploiting the ‘China shock’ as an exogenous shock to competition, it investigates the causal effect of competition on the allocation of capital within publicly listed US firms, as well as on the conglomerate discount. Finally Section 6 concludes.

2 Setup of the model

We develop a model of heterogeneous firms in which single-segment firms (SSF) and multi-segment firms (MSF) coexist in a market with monopolistic competition. A SSF produces one type of good and has a simple organisation in which the firm’s owner has full control over production. A MSF is a conglomerate operating unrelated segments, each of which produces a different type of goods. The owner has control over the core segment, but delegates control over non-core segments to the divisional managers.

Our theory of MSFs builds on the literature on multi-product firms that features flexible technology. Each firm has a core competence in producing one *core* good. The firm can introduce other *non-core goods* that have higher production costs than the core good, as it requires more know-how than the firm’s core competence; see Bernard et al. (2010), Eckel and Neary (2010), Dhingra (2013), or Nocke and Yeaple (2014). In particular, we build on the framework developed in Mayer et al. (2014) to model MSFs with unrelated segments.⁷

2.1 Endowments and preferences

A country is endowed with a fixed stock of capital K and populated by a continuum of households of measure L . Each household is endowed with one indivisible unit of time, which is supplied either as labor or managerial effort.

Households have identical preferences defined over a continuum of measure V of varieties of horizontally differentiated good and one homogeneous outside good. The utility

⁷Our theory aims to explain the allocation of capital within a conglomerate firm across different products that belong to vertically unrelated sectors. Thus, similar to Mayer et al. (2014), our model does not feature cross-price elasticities among different goods produced by the same firm (the so-called *cannibalisation effect*).

function is given by:

$$U = q_o^c + \alpha \int_0^V q_v^c dv - \frac{\beta}{2} \left(\int_0^V q_v^c dv \right)^2 - \frac{\gamma}{2} \int_0^V (q_v^c)^2 dv, \quad (1)$$

where q_o^c represents the consumption of an homogeneous outside good, while q_v^c represents the consumption of a variety v of a differentiated good.⁸

Households maximise their utility given by Equation (1) subject to the budget constraint $p_o q_o^c + \int_0^V p_v q_v^c dv \leq I^c$, taking the price of outside good p_o and varieties p_v as given. I^c denotes individuals' income. As in Melitz and Ottaviano (2008) we assume that the outside good is always consumed, $q_o^c > 0$. Thus, the outside sector absorbs any residual expenditure (and resources) not allocated to the differentiated good sector. Demand for a differentiated good is zero at a certain choke price. The choke price is a general equilibrium outcome since it depends on the measure of varieties V and their average price.⁹

The indirect utility of a consumer endowed with income I^c is linear in income

$$W(I^c) = I^c + \left(\frac{1}{2} \frac{V(\alpha - \bar{p})^2}{\gamma + \beta V} \right) + \frac{\sigma_p^2 V}{2\gamma}, \quad (2)$$

and depends on the measure of varieties V , on their average price \bar{p} , and on the variance of prices σ_p^2 . The marginal utility of income is constant and equal to 1. Therefore, a pecuniary compensation is a perfect substitute for personal satisfaction. This is an important feature of the model to microfound the structure of incentives.

2.2 Production

The outside sector is competitive. Production of outside goods combines labor and capital as perfect substitutes, with the marginal productivity of labor equal to 1 and the marginal productivity of capital equal to $\theta > 0$. We assume that in equilibrium both labor and

⁸For a detailed discussion on the properties of this utility function, see Melitz and Ottaviano (2008). Parameters $\alpha > 0$ and $\beta > 0$ account for the substitution patterns between homogeneous goods and varieties of differentiated goods. The willingness to smooth consumption across differentiated goods increases with the parameter $\gamma > 0$, where higher γ implies lower substitution.

⁹We outline the derivation of the consumer's problem in the appendix. See Melitz and Ottaviano (2008) and Mayer et al. (2014) for a detailed analysis of the choke price and of the properties of the demand system implied by (1).

capital are employed in the outside sector. Without loss of generality we choose the outside good to be the numeraire, which implies that the price of labor is 1 and the rental price of capital is θ .

Production of varieties of differentiated goods employs labor and capital according to a constant returns to scale Cobb-Douglas technology. One variety corresponds to one and only one product, which is supplied by one firm. For the sake of expositional clarity we assume that firms supply at most one product in the same market segment and are eventually active in multiple market segments.¹⁰

The core competence of a firm is sufficient to develop its *core segment*. If the firm is active in other segments, additional know-how is necessary to customise a firm's operations, which implies that *non-core segments* are characterized by additional customization costs. The core segment of each firm is indexed with $i = 0$, the eventual non-core segments are indexed with $i = 1, 2, \dots, m$ for a discrete number of segments m .

Firms are heterogeneous in the core cost c and in the vector of customization costs $\mathbf{z} = \{z_i\}_{i=0}^m$. After entry, a firm learns about its core cost c as a random draw from an exogenous continuous distribution $G(c)$. The distribution of customization costs, unconditional on firm characteristics, is known and exogenous, with cumulative density function $F(z)$, which is continuous and convex.

Since our goal is to model the behavior of firms whose organization is a conglomerate of unrelated segments, the model abstracts from vertical linkages between segments and economies of scope, such that production in each segment can be examined in isolation. The production function in a segment i with customization cost z_i in a firm with marginal cost of the core competence c is given by:

$$y(z_i c) = \frac{\varphi}{z_i c} l(z_i c)^\lambda k(z_i c)^{1-\lambda}, \quad (3)$$

where $y(z_i c)$ is output, and $l(z_i c)$ and $k(z_i c)$ are labor and capital used in production. Parameter $\lambda \in (0, 1)$ is the elasticity of output with respect to labor. Coefficient $\varphi = \left(\frac{1-\lambda}{\lambda\theta}\right)^{-(1-\lambda)} + \theta \left(\frac{\lambda\theta}{1-\lambda}\right)^{-\lambda}$ is a constant.

Firms maximise profits subject to the technology given by Equation (3). Profit max-

¹⁰This keeps the analysis at the segment level, avoiding the additional complexity of multi-output production within segments. As long as resources are allocated at the segment level first and then by product in a consistent two-stage budgeting process with exact output aggregation, there are no distinctive implications for the allocation of capital across segments.

imization implies that the marginal cost in segment $i = 0, 1, 2, \dots$ equals $z_i c$. Within a given firm we sort products by customization cost in increasing order, such that $z_0 = 1 < z_1 < z_2 < \dots < z_m$. The equilibrium quantity, price, revenue, employment of labor, employment of capital, profit and return on assets – measured as the ratio of profits to the cost of capital – in a segment with marginal cost $z_i c$ are:

$$q(z_i c) = \frac{L}{2\gamma} (c_D - z_i c) \quad (4a)$$

$$p(z_i c) = \frac{1}{2} (c_D + z_i c) \quad (4b)$$

$$r(z_i c) = \frac{L}{4\gamma} (c_D^2 - (z_i c)^2) \quad (4c)$$

$$l(z_i c) = \frac{z_i c}{\varphi_l} \frac{L}{2\gamma} (c_D - z_i c) \quad (4d)$$

$$k(z_i c) = \frac{z_i c}{\varphi_k} \frac{L}{2\gamma} (c_D - z_i c) \quad (4e)$$

$$\pi(z_i c) = \frac{L}{4\gamma} (c_D - z_i c)^2 \quad (4f)$$

$$roa(z_i c) = \frac{\varphi_k}{2\theta} \left(\frac{c_D}{z_i c} - 1 \right), \quad (4g)$$

where $\varphi_l = \left(\frac{\lambda\theta}{1-\lambda}\right)^{\lambda-1} \varphi$ and $\varphi_k = \left(\frac{\lambda\theta}{1-\lambda}\right)^\lambda \varphi$ are constants. The variable c_D is the maximum cost below which demand is positive in the firm's domestic market. We refer to c_D as the “cutoff cost”. It is determined in equilibrium and will be a sufficient statistic to summarise the degree of competition in the output market, with a lower c_D representing tougher competition.

The return on assets is proportional to the markup, defined as the difference between price $p(z_i c)$ and marginal cost $z_i c$, over marginal cost. Therefore, the model predicts that segments with a different marginal cost are characterized by a different return on asset, despite belonging to the same firm.¹¹ This dimension of heterogeneity will be important in the allocation of capital through the internal capital market of a MSF.

¹¹The demand system is characterized by variable markups thanks to the quasi-linear quadratic utility; see Melitz and Ottaviano (2008).

3 Multi-segment firms

A MSF differs from a SSF for one essential aspect, concerning the information within the organization: in a MSF the true cost of a non-core division is known to the divisional manager only and it is not verifiable by the firm's owner. The allocation of capital in the internal market of a MSF is characterised by:

- (i) *Empire building* managers who strategically misreport the true cost of their division to maximise their private benefit from running a bigger division;
- (ii) *Winner picking* firms that allocate capital by ranking managers according to their divisions' return on assets, which subjects managers to competition for funds.¹²

Given this setup, incumbent firms decide whether to become a MSF by opening a certain number of non-core divisions $m = 1, 2, \dots$. If they choose $m = 0$, i.e., only operate their core division, they are a SSF. Opening a non-core division requires to pay a managerial compensation:

$$f_M + \eta\pi(z_i c), \tag{5}$$

where f_M is a fixed managerial wage and $\eta \in [0, 1]$ is a fraction of the profit of the division with marginal cost $z_i c$ that is paid to the divisional manager. Modeling the managerial cost as in Equation (5) accounts for the two components of executive's compensation which are typically designed to reach an optimal outcome of a principal (firm) agent (manager) problem within the organization, namely a fixed pay in cash captured by f_M and a performance-based pay captured by $\eta\pi(z_i c)$.

Applicants for a managerial position do not know with certainty whether they will be appointed or not; we describe these aspects below. They know the fixed component of managerial compensation and the outside option in case they are not appointed, which is to become employees at a wage $w = 1$ with certainty. We assume that managers are infinitely averse to income risks. This implies that the fixed component of manager's compensation is the same for every MSF and it is equal to the minimum value that fulfills the manager's participation constraint, $f_M = 1$.

¹²Empire building managers have been introduced by Jensen (1986). The idea of an internal capital market disciplined by winner picking has been proposed in Stein (1997). Both arguments have since been tested extensively finding support in the data; see Stein (2003) for a review.

3.1 The decision to become a MSF

Subtracting the cost of opening a division from the profit that a non-core division generates yields the value to the firm from the non-core division. The value is decreasing in the marginal cost of the division for every $\frac{z_i c}{c_D} \leq 1$, and positive for $z_i c \leq c_D - \sqrt{\frac{4\gamma f_M}{(1-\eta)L}}$. Therefore, a necessary condition for a profit maximizing firm to become multi-segment is:

$$c < c_D - \sqrt{\frac{4\gamma}{L}} \equiv c_M(c_D), \quad (6)$$

where we have substituted for the minimum managerial compensation, i.e. $f_M = 1$ and $\eta = 0$, at which the firm can hire a manager. Firms endowed with a core competence cost lower than the multi-segment cutoff $c_M(c_D) < c_D$ look for divisional managers to become a MSF.

3.2 Empire building managers

In addition to utility derived from consumption (given by Equation 2), managers' welfare also consists of an appetite for running their division with more capital than what is sufficient for maximising the value that accrues to the firm. Crucially, only the manager knows the true customization cost of her own division, which we denote by $x_i \geq 1$. The manager can use this private information to attract more capital $k(z_i c) > k(x_i c)$ and extract a non-verifiable private benefit from running a bigger division.

Segment performance is observable and can be verified by the firm. Instead, the firm cannot verify whether the volume of output supplied in the market by a non-core division is the maximum obtainable given the allocation of resources to the division.

To see this, notice that a manager at a firm with core marginal cost c endowed with true customization cost x_i and reporting a customization cost z_i runs production with the technology given by Equation (3). The allocation of labor and capital, $l(z_i c)$ and $k(z_i c)$, is given by Equations (4d)–(4e), with total factor productivity $(x_i c)^{-1}$ instead of $(z_i c)^{-1}$. Thus, the manager commits to deliver in the market an output supply of $q(z_i c) = y(z_i c)$ units, but the maximum units of output obtainable running the division at the true productivity is $\frac{z_i}{x_i} y(z_i c)$.

In line with the finance literature, we assume that a manager's private benefit is mea-

sured by the excess of output capacity $\frac{z_i}{x_i}y(z_i c) - q(z_i c)$, conditional on $k(z_i c) > k(x_i c)$.¹³ Based on this conjecture, we define the manager's private benefit as:¹⁴

Definition. *Manager's non-pecuniary private benefit is represented by the excess of output capacity*

$$b(\mu; x_i, c, c_D) : \equiv \frac{z_i}{x_i}y(z_i c) - q(z_i c) = \frac{L}{2\gamma}(\mu - 1)(c_D - \mu x_i c) \quad (7)$$

conditional on $k(z_i c) > k(x_i c)$. It is null otherwise. $\mu = z_i/x_i$ is the factor of mis-reporting.

The main insights from the definition of managers' private benefits are: (i) managers gain a private benefit only if they are capable to obtain a greater capital allocation $k(z_i c) > k(x_i c)$ without under-reporting their effective cost, i.e. $\mu \geq 1$; (ii) managers enjoy a greater private benefit the more they over-report, i.e. the higher μ ; (iii) managers enjoy greater private benefits the better their know-how (lower x_i) and the better the firm they match with (lower c); (iv) tougher competition, i.e. a lower cutoff c_D , decreases the private benefit.

This structure has two main implications for the organization of a MSF. First, although managers are all willing to apply for a position in a better firm, only a selected group of managers can be successful, depending on how their effective cost compares with firms' core marginal cost c and market cutoff c_D . Second, while managers have the incentive to report a higher customization cost z_i , the profit of the division decreases with the customization cost. Therefore, the incentives of firm and managers are not aligned.

3.3 Winner picking

A MSF opening $m = 1, 2, \dots$ non-core divisions announces a tournament to hire as many divisional managers. There is an unrestricted number of candidate managers, each endowed with an idiosyncratic level of know-how.

¹³Scharfstein and Stein (2000) model the private benefit of empire building managers as an excess of output capacity.

¹⁴In the appendix we show that all the results are robust to a more general definition of private benefit, as represented by any continuous and twice differentiable function $b(\mu; x_i, c, c_D)$ that satisfies a minimal set of sufficient conditions.

The information set of the two parties in the tournament is as follows. The toughness of market competition c_D is public knowledge. Managers know the number of divisions m a firm is opening, as well as the firms' core marginal cost. While the distribution of reported customization costs $z \sim F(z)$ is public knowledge, the know-how of an individual candidate is not observable by the firm or by other managers. The rules of the tournament are:

1. The firm meets randomly with a large number of candidates. Independently and simultaneously, each candidate is asked to propose a customization cost z_i at which she would run a division.
2. It is understood by both parties that, in case an agreement is reached, the division will perform according to the equilibrium allocation (4a)-(4g), given the proposed customization cost. These performances are verified by the firm ex-post, and the punishment for missing these targets is prohibitive.
3. The firm ranks managers by return on asset given the proposed customization cost ($roa(z_i c)$) and commits to finance the first m managers, with the corresponding capital allocation $k(z_i c)$.

Given the information set and the rules of the tournament, a MSF meets with a selected pool of managers that is determined by the firms' core marginal cost and the market cutoff cost. In fact, only managers who are capable of proposing a customization cost $z \leq c_M(c_D)/c \equiv \bar{z}(c, c_D)$ can lead a profitable division at a firm with core marginal cost c when the cutoff cost is c_D . Moreover, the sole goal of candidate managers is to be hired, i.e. to be ranked among the best m applicants, since all other aspects of their appointment (such as resource allocation and targets) are fixed.

It follows that the distribution of reported customization costs among applicants to the same firm is endogenous, as it depends on the firm- and market-specific cutoff $\bar{z}(c, c_D)$. Yet, within the pool of applications, each candidate competes against arbitrarily many other candidate managers, while taking the firm-specific distribution of reported customization costs among them as given. The consequence is that the customization costs reported by managers who win the tournament are random draws from the firm-specific conditional distribution of the joint event $\{z_i \leq \bar{z}(c, c_D) \forall i = 1, \dots, m\}$.

In this context the firm cannot gain by providing incentives to managers. As we show in the appendix, offering a share of its profits to managers does not improve the expected

profit from non-core divisions. Intuitively, the design of the tournament is such that managers have no bargaining power vis-à-vis the firm, as the firm can always meet with another applicant who could offer a lower customization cost. Therefore, it is optimal for a MSF not to offer any profit share, so $\eta = 0$.

A trade-off emerges between opening many but on average worse non-core divisions or opening few but on average more profitable non-core divisions.¹⁵ However, with no economies of scope among unrelated segments, the two forces cancel each other out such that the optimal number of non-core divisions is undetermined (i.e. the expected profit from the pool of non-core divisions does not depend on the number of non-core divisions). This insight is sufficient to describe the probability that an application for a managerial position is financed:

Lemma. *The probability that a manager offering a customization cost $z_i = \mu x_i < \bar{z}(c, c_D)$ is financed is:*

$$\psi(\mu; x_i, c, c_D, m) = 1 - \frac{F(\mu x_i)}{mF(\bar{z}(c, c_D))} \quad (8)$$

where : $\frac{\partial \psi}{\partial \mu} < 0$ $\frac{\partial \psi}{\partial x_i} < 0$ $\frac{\partial \psi}{\partial c} < 0$ $\frac{\partial \psi}{\partial m} > 0$ $\frac{\partial \psi}{\partial c_D} > 0$,

and $\frac{\partial^2 \psi}{\partial \mu^2} \leq 0$ $\frac{\partial^2 \psi}{\partial \mu \partial x_i} < 0$ $\frac{\partial^2 \psi}{\partial \mu \partial c} < 0$ $\frac{\partial^2 \psi}{\partial \mu \partial m} > 0$ $\frac{\partial^2 \psi}{\partial \mu \partial c_D} > 0$.

As the firm ranks managers by reported customization cost, managers internalize that they are in competition for funds with other managers. The winner picking practice thus exerts discipline on the managers, as their probability of being financed declines as the factor of mis-reporting μ increases.

3.4 Excess capital allocation

Although the true customization costs are unknown to the firm, it knows the following: First, manager's welfare derived from consumption is determined by Equation (2). In-

¹⁵On the one hand, fewer non-core divisions imply lower customization costs (because a candidate manager has a lower probability to be in the top- m when offering a higher customization cost) and thus a higher expected profit per division. On the other hand, the expected total profit grows with the number of non-core divisions.

deed, every candidate manager earns at least as much as an employee. Second, managers appetite for empire building described in Equation (7) leads to excess output capacity. Third, applicant managers face a probability to be financed, that obeys to the properties (8). The firm internalizes that rational managers choose the factor of mis-reporting that maximises the expected payoff:

$$\mu_i^* = \arg \max_{\mu \geq 1} \psi(\mu; x_i, c, c_D, m) b(\mu; x_i, c, c_D) , \quad (9)$$

The manager's problem (9) has a unique solution, which is characterized by the following properties:

Proposition 1. *Better managers, i.e. those characterized by $1 \leq x_i < \frac{c_D}{2c}$, over-report the customization cost $\mu_i^*(\eta; x_i, c, m, c_D) > 1$, and the comparative statics describing their optimal decision are such that:*

- (1.1) μ_i^* is decreasing in the true customization cost of the division x_i
- (1.2) μ_i^* is decreasing in the core competence cost of the firm c
- (1.3) μ_i^* is increasing in the number of non-core divisions m
- (1.4) μ_i^* is increasing in the market cutoff cost c_D

instead, worse managers, i.e. those characterized by $\frac{c_D}{2c} \leq x_i < \frac{c_M(c_D)}{c}$, report their customization cost x_i .

Candidate managers who report a customization cost $z_i > \frac{c_D}{2c}$ reveal themselves as “bad managers” types. This follows from the the fact, given a true customization cost of $x_i < \frac{c_D}{2c}$ a rational manager is strictly better off by reporting $z_i \leq \frac{c_D}{2c}$: she attains both a greater payoff and a greater probability of being financed. Candidate managers who report a customization cost $z_i \leq \frac{c_D}{2c}$ thus reveal themselves to be of the “good managers” type. Otherwise, by under-reporting their effective cost they would commit to performances (see Equations (4a)–(4g)) that they cannot deliver, which would lead to a prohibitive punishment.

The first order condition of the manager's problem (9) can be written as the semi-elasticity of managers' payoff $b(\mu)$ with respect to the over-reporting factor $\xi_{pay}(\mu)$ equal to the semi-elasticity of the probability of being financed $\psi(\mu)$ with respect to the over-reporting factor $\xi_{\psi}(\mu)$. The definition of private benefit (7) and the properties of the probability of being financed (8) are sufficient to prove that $\xi_{pay}(\mu)$ is decreasing in μ ,

while $\xi_\psi(\mu)$ is increasing in μ , and $\xi_{pay}(1) > \xi_\psi(1)$.¹⁶ The semi-elasticities $\xi_{pay}(\mu)$ and $\xi_\psi(\mu)$ correspond to two curves that cross in a unique point in the plan drawn over the support $\mu > 1$. We refer to $\xi_{pay}(\mu)$ as the curve describing the *marginal gain in the expected payoff*, and we refer to $\xi_\psi(\mu)$ as the curve describing the *marginal loss in the probability of being financed*. The driving forces behind the comparative statics in Proposition 1 are shown in Figure 2.

Panel 2a summarizes results (1.1), (1.2) and (1.4) from Proposition 1. The second order derivatives in Equation (7) show that the gains in terms of private benefits due to over-reporting decline in the effective marginal cost $x_i c$ and increase in the cutoff cost c_D . Therefore, a higher marginal cost relative to the market cutoff pushes down the curve describing the marginal gain in the expected payoff. The second derivatives of the probability of being financed in Equation (8) shows that managers of divisions with higher marginal costs relative to the cutoff cost have less room to over-report, and that their likelihood to be financed declines as they over-report more. Thus, the decline in the probability of being financed is larger the greater the ratio $\frac{x_i c}{c_D}$ – the corresponding curve moves up. In sum, the optimal level of over-reporting is lower when the true customization cost of a division and/or the firm core competence cost are higher relative to the cutoff cost.

Panel 2b describes result (1.3) from Proposition 1. Over-reporting is more pronounced in firms with a greater number of non-core divisions. As more positions need to be filled, it is more likely that a manager's offer will be in the range of selected offers, all else equal. The manager thus has less to lose by over-reporting: the curve describing the change in the probability of being financed shifts down as the number of non-core divisions increases. The expected payoff is not affected by the number of divisions. Therefore, managers' optimal level of over-reporting is higher the greater the number of non-core divisions.¹⁷

The analysis on capital allocation across segments within MSFs has four implications. First, managers running a division with relatively low marginal costs have more room for over-reporting, while still facing a relatively high probability of being financed. Therefore, within-firms, managers of better divisions over-report their costs relatively more. Between firms, over-reporting is larger in better firms (with lower core marginal cost).

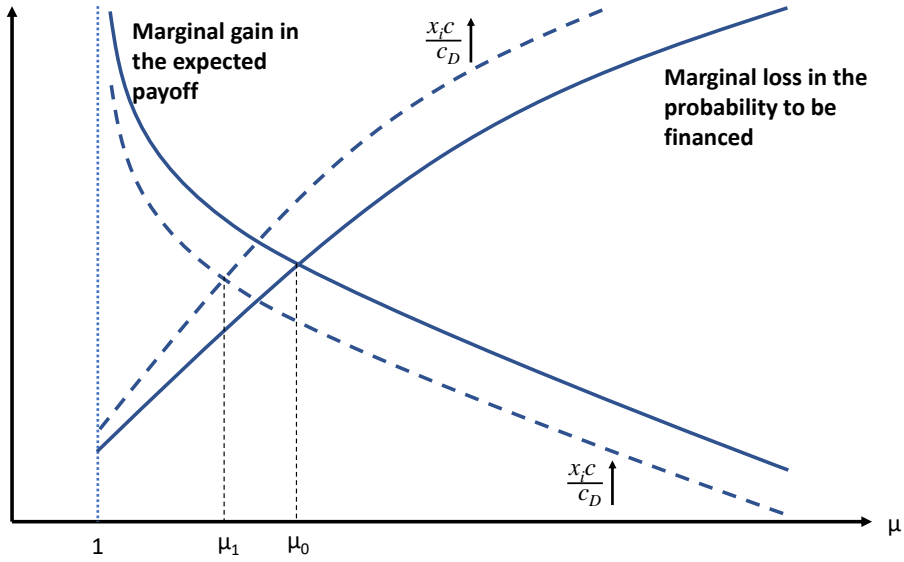
Second, over-reporting is lower if there is more market competition, i.e. the lower the

¹⁶We prove these results in Lemma 1.1 - 1.4 of the proof of Proposition 1, in the appendix.

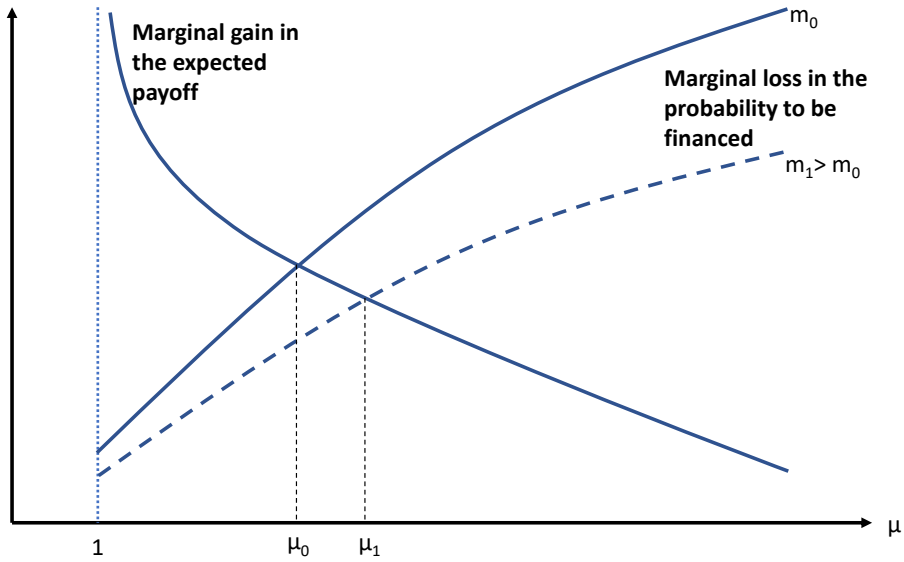
¹⁷In the appendix we show that result (1.3) in Proposition 1 is supported by the data: average marginal costs are higher among firms with a greater number of non-core segments.

Figure 2: Comparative statics on the optimal factor of over-reporting

(a) Over-reporting is lower the higher the effective marginal cost $x_i c$ relative to the cutoff cost c_D



(b) A greater number of non-core divisions m increases over-reporting



cutoff cost c_D . A lower market cutoff reduces the range of costs at which a division is financed. Managers internalise this channel when they over-report the cost of their division. The toughness of competition in the output market thus acts as a disciplining device on managers' strategic over-reporting. Through this mechanism, which is distinctive to our theory, the marginal cost of a non-core division in a MSF's responds endogenously to external changes in competition. Therefore, the model yields direct implications on how competition affects resource allocation within MSF, and these implications go beyond a simple reallocation of output market shares.¹⁸

Third, the model predicts that the allocation of capital across segments (given by Equation (4e)) follows an inverted-U shaped function of marginal costs at the segment level. For better managers (i.e. those with $z_i c < c_D/2$), allocated capital increases with marginal costs, but eventually declines in marginal costs among worse managers (those with $z_i c \geq c_D/2$).

Fourth, market toughness affects the allocation of capital within firms by changing managers' strategic choice of over-reporting. The asymmetric over-reporting of customization costs (which is more pronounced the lower a segment's true marginal cost) implies that, within the same MSF, the better non-core divisions receive more capital than under true reporting; and between firms, better MSFs allocate too much capital to their best non-core divisions, relative to a world of no over-reporting.

In conclusion, Proposition 1 describes managers' strategic behavior, given the true marginal cost $x_i c$, market cutoff cost c_D and the number of non-core divisions at the firm m , for an arbitrary c.d.f. of reported customization costs $F(z)$. Changes in the degree of over-reporting thus affect the allocation of capital within MSFs.

Importantly, the patterns of capital allocation predicted by the model do not stem from deviations of marginal products of capital around its rental rate, as in the mis-allocation approach based on Hsieh and Klenow (2009). In our model every firm and segment equates the marginal product of capital to the rental price of capital in the external market. Instead, capital mis-allocation results from informational frictions within the organization that allow divisional managers to distort the functioning of the internal capital market in MSFs.

¹⁸In Mayer et al. (2014), market toughness reallocates market shares from the worst products to the best products of a multi-product firm. Results that go in the same direction are common in many models of multi-product firms, see Hopenhayn (2014). However, to the best of our knowledge, our theory of MSFs is the first to highlight a mechanism in which marginal costs also responds endogenously to competition.

4 Free entry equilibrium in open economy

Entry in the differentiated good sector is costly. Entrants undertake an irreversible investment of $f_E > 0$ units of labor through which they learn about their core marginal cost $c \sim G(c; \rho)$, where the parameter ρ accounts for the concentration in the distribution of core marginal costs.

Firms that are not profitable exit at zero value. Firms with $c \leq c_D$ produce at least in their core segment, making a profit $\pi(c)$. Among incumbent firms, those that satisfy the necessary condition (6), i.e. $c \leq c_M(c_D)$, look for managers and become MSFs with probability $F(\bar{z}(c, c_D))$. Within the group of MSFs, non-core divisions with customization cost $z \leq \bar{z}(c, c_D)$ are financed in a firm with core competence cost c , for a given cutoff cost of c_D . In a free entry equilibrium with a positive mass of firm entrants the expected value before entry must be equal to the sunk cost of entry:

$$\begin{aligned} \Pi(c_D) &= \int_0^{c_D} \pi(c) dG(c; \rho) \\ &+ \int_0^{c_M(c_D)} \left(\int_1^{\bar{z}(c, c_D)} [\pi(zc) - f_M] dF(z) \right) dG(c; \rho) = f_E . \end{aligned} \quad (10)$$

The free entry condition (10) determines the cutoff cost c_D . Every exogenous shock leading to more competition, i.e. lower cutoff cost c_D , has general equilibrium effects improving the set of both firms and segments within MSFs. In our model, we focus on the channel of international trade as the source of changes in competition.

4.1 Open economy

In an open economy setting, firms sell in their domestic market, but might also export to a foreign market. For the sake of exposition we assume that the foreign market is symmetric to the domestic one, that product markets are segmented, and that exported products are subject to a per-unit trade cost $\tau \geq 1$.¹⁹

Under these circumstances, it can be shown that a domestic producer with core marginal cost c would serve the foreign market as a local producer with core marginal cost τc . Firms export to a foreign market only in segments in which they make a positive

¹⁹Mayer et al. (2014) show how the same framework can be extended to many countries with asymmetric characteristics and bilateral trade costs.

profit. Thus, only firms with a core competence cost $c \leq c_D/\tau$ become exporters, at least for their core segment. Among MSFs, only non-core segments with a marginal cost $z_i c \leq c_D/\tau$ have positive sales in the foreign market. Thus, expansion into a foreign market and import competition affect the expected value of a firm at entry into the domestic market.

The overall effect of international trade on competition depends on the relative strength of these two forces. The free entry condition (Equation (10)) evaluated in the open economy setting determines the cutoff cost for entry in the domestic market c_D as an increasing function of the trade cost τ , such that $\frac{\partial c_D}{\partial \tau} > 0$. As is well known in the trade literature, the cutoff cost c_D is a sufficient statistics to interpret the effects of tougher competition on welfare and aggregate outcomes.²⁰

4.2 Tobin's Q and the conglomerate discount

We now show that conglomerate discount is a function of the allocation of capital within firms. Total profits and capital of a firm with core marginal cost c and customization costs $\mathbf{z} = \{z_0, z_1, \dots, z_m\}$ are given by $\pi_{tot}(c) = \sum_{i=0}^m [\pi(z_i c) + \mathbf{1}_{[z_i c]} \pi(z_i \tau c)]$ and $k_{tot}(c) = \sum_{i=0}^m [k(z_i c) + \mathbf{1}_{[z_i c]} k(z_i \tau c)]$ respectively; where $\mathbf{1}_{[z_i c]}$ is an indicator function that is $\mathbf{1}_{[z_i c]} = 1$ if there are exports in segment i of a firm c and zero otherwise. We refer to the value of total firm capital $\theta k_{tot}(\mathbf{z}, c)$ as “book value”, and the discounted lifetime stream of profit $\frac{1+\theta}{\theta} \pi_{tot}(\mathbf{z}, c)$ as “market value” of the firm. The market-to-book ratio, or Tobin's Q is given by:

$$T(\mathbf{z}, c) = \frac{(1+\theta)\varphi_k}{2\theta^2} \frac{c_D^2 - 2c_D \mathbb{A}[\mathbf{z}c] + \mathbb{A}[(\mathbf{z}c)^2]}{c_D \mathbb{A}[\mathbf{z}c] - \mathbb{A}[(\mathbf{z}c)^2]}. \quad (11)$$

where $\mathbb{A}[\mathbf{z}c] = [1 + m + \sum_{i=0}^m \mathbf{1}_{[z_i c]}]^{-1} \sum_{i=0}^m (z_i + \mathbf{1}_{[z_i c]} z_i \tau) c$ and $\mathbb{A}[(\mathbf{z}c)^2] = [(1 + m) + \sum_{i=0}^m \mathbf{1}_{[z_i c]}]^{-1} \sum_{i=0}^m (z_i^2 + \mathbf{1}_{[z_i c]} z_i^2 \tau^2) c^2$ are, respectively, the first and second moment of the distribution of marginal cost across divisions of the firm. Tobin's Q decreases with average marginal cost $\mathbb{A}[\mathbf{z}c]$ and, conditional on the average, increases with the variance of marginal costs across divisions $\mathbb{A}[(\mathbf{z}c)^2] - \mathbb{A}[\mathbf{z}c]^2$.²¹

²⁰The solution of the free entry condition (10) is obtained in closed form in the appendix. Our solution generalizes comparable existing frameworks, such as Mayer et al. (2014), while preserving the tractability of aggregate results.

²¹This result on mis-allocation within firms represents a fundamental difference to the measure of mis-allocation across firms in the literature (Hsieh and Klenow, 2009). In our model, the headquarters is in charge of allocating capital across segments. Based on ‘winner-picking’, it re-allocates capital from segments with low return on assets to segments with high return on assets. Greater dispersion of marginal

Over-reporting affects Tobin’s Q , and hence the conglomerate discount, by changing average marginal costs and their dispersion. First, it directly increases average marginal cost $\mathbb{A}[zc]$. Second, holding average marginal costs fixed, the relatively more pronounced over-reporting at better divisions decreases the dispersion of marginal costs $\mathbb{A}[(zc)^2] - \mathbb{A}[zc]^2$, because costs of better divisions move closer to costs of worse divisions. Intuitively, the closer divisions are in their costs, the less valuable is the winner picking role of the internal capital market. Both channels decrease the Tobin’s Q of MSFs.

Single-segment firms are not subject to over-reporting, as there are no informational frictions between the owner and any divisional manager. Therefore, although the core marginal cost of a MSF (c_{msf}) is lower than the core marginal cost of a SSF (c_{ssf}), the model accounts for the possibility of a “conglomerate discount”, such that $T(z, c_{msf})/T(1, c_{ssf}) < 1$. A conglomerate discount arises if the difference in core marginal costs between single- and multi-segment firms ($c_{ssf} - c_{msf} > 0$) is sufficiently small relative to the cost structure of non-core segments within the MSF. The model shows that the over-allocation of capital to better divisions of the MSF increases the average and decreases the dispersion of marginal costs across segments within a MSF. Both channels inflate the cost structure of non-core divisions, for a given core marginal cost. Therefore, a conglomerate discount reflects mis-allocation in the internal capital market of MSFs. The theory is also consistent with the conclusion that highly productive MSFs may not exhibit a conglomerate discount, despite a distorted allocation of capital.²² Exporters are the most productive firms (in the model and in the data) which explains why the conglomerate discount may disappear or even become a premium for exporting MSFs (see Figure 1).

costs *within* firms indicates a greater role for the headquarters to reallocating capital across divisions. In this sense, more dispersion within firms is “good”. In contrast, greater dispersion of marginal revenue products across firms signals that capital does not move to the firms with the highest returns and thus dispersion across firms indicates mis-allocation *across* firms in standard models of mis-allocation.

²²Maksimovic and Phillips (2013) review recent literature on the presence of a conglomerate discount and conclude that empirical evidence is mixed. Our paper provides an explanation for why not all multi-segment firms suffer from a conglomerate discount. Conglomerates exposed to international competition may trade at a premium rather than a discount, due to the disciplining effect of competition on over-reporting of costs within multi-segment firms.

5 Taking the model to the data

In this section we use our model to derive a set of predictions and then test them with US firm- and segment-level data. In line with these predictions, we show that *(i)* firms' Q declines in average marginal costs and increases in their dispersion; *(ii)* that the relation between capital allocation and marginal costs across segments follows an inverse U-shape; and *(iii)* that informational frictions distort marginal costs, especially in efficient segments, and are thus an important determinant of capital allocation within multi-segment firms. Finally, we *(iv)* demonstrate the disciplining role of competition on internal capital markets and over-reporting.

5.1 Data and main variables

Compustat provides yearly balance sheet information on publicly listed US firms. The sample period spans 1999 to 2016. In addition, we observe sales, assets, profits, and return on assets at the 4-digit SIC segment level. We follow the literature and drop observations for which the sum of reported segment sales does not fall within 25% of total firm sales. We further eliminate segments with the name 'other' or a SIC classification of 0, missing and anomalous accounting data (eg missing sales, assets, capital expenditure, depreciation, operating profits; or zero depreciation, capital spending greater than sales or assets, capital spending less than zero). Finally, we eliminate firms and segments that operate in regulated industries (see eg Ozbas and Scharfstein (2010)).²³ Importantly, we follow Ozbas and Scharfstein (2010) and focus on unrelated segments. To this end, we use BEA data on input-output relationships among industries and exclude all vertically related industries (an industry that buys/sells more than 10% of its inputs/outputs from/to the other industry). Firms in the sample operate in up to ten industries (segments). All firms that have only one segment are classified as single-segment.

Central to the analysis is the segment-level return on assets, which we use to derive segments' marginal costs relative to the market cutoff ($z_i c/c_D$ in the model). As is standard, we compute segment profits as operating income plus depreciation; and we compute return on assets as profit over asset.

Calculating profits from income statements can lead to a biased measure of actual

²³These cover SIC codes 4000–4999, 6000–6199, and 6300–6499.

profits.²⁴ We thus adjust segment-level return on assets as follows: First, we follow De Loecker et al. (2020) to compute firms’ profit rates from firms’ balance sheet items.²⁵ Balance sheet information required to compute the profit rate is only available at the HQ level. In a second step we thus adjust each segment’s return on asset with the respective ratio between the profit rate and return on assets at the HQ level.²⁶ Adjusting the segment-level return on assets in this way alleviates concerns that could arise if we were to compute return on assets solely based on segments’ income statements.

In the main analysis, we look at the effect of competition on marginal costs. However, marginal costs might be in part determined by other potentially confounding factors. In addition to using an instrumental variable approach, we purge our measure of marginal costs from confounding factors as follows: We regress the measure of segment-level relative marginal costs computed from the (adjusted) segment-level return on assets on the yearly average interest rate, average capital to labor ratio, average concentration (Herfindahl-Hirschman index, HHI) and average sales growth in each firms’ industry. In addition, we factor out common trends through year fixed effects, as well as differences across firm size through dummies for quartiles of the employment distribution. Firm size dummies also partly control for differences in technology across firms.²⁷ The residual from this regression is our measure of segment marginal costs.²⁸

²⁴For example, in the presence of adjustment frictions, the accounting measure does not adequately reflect the actual expenditure on capital (De Loecker et al., 2020).

²⁵The profit rate is calculated as total sales minus all costs (including overhead and the expenditure on capital) as a share of sales. Crucially, this measure of the profit share differs from the accounting-based computation of profits, as it uses a measure of capital obtained from the balance sheet and not the income statement (see De Loecker et al. (2020)).

²⁶Specifically, $roa_s^{adjusted} = roa_s \times \frac{profit\ rate_f}{roa_f}$. The underlying assumption is that the observed discrepancy between the profit rate and return on assets at the HQ-level also occurs at the segment level.

²⁷We estimate $rmc_{fst} = \alpha + \delta_1 interest_{st} + \delta_2 (k/l)_{st} + \delta_3 HHI_{st} + \delta_4 \Delta sales_{st} + \delta_5 quartiles_f + \tau_t + \varepsilon_{fst}$, where f denotes firm, s segment and t time. The introduction of sectoral interest rates, concentration and sales growth captures changes in the competitive environment due to market access, aggregate supply and aggregate demand channels. The sectoral capital to labor ratio, firm size dummies and year fixed effects account for common trends in technical change and differential effects due to economies of scale. All measures are computed from Compustat data. The interest rate is the average interest expense over total debt, the capital labor ratio is total fixed assets to employment, and the HHI is based on total sales.

²⁸We also explicitly test for whether firms engage in cost-cutting innovation, as changes in segments’ technology could coincide with changes in competition, both of which could affect marginal costs. We address this concern through a placebo exercise: As single-segment firms are not subject to internal informational frictions competition should have no effect on marginal costs through its effect on over-reporting. We show below that changes in Chinese imports do not affect marginal costs in single-segment firms.

We further collect information on CEO tenure and the number of boards from Execucomp and BoardEX. Specifically, for each firm we compute CEO tenure as 2013 minus the year the average CEO joined the company, and compute the total number of boards the average CEO sits on. We use data on CEO tenure and the number of boards as a proxy for informational frictions. CEOs that have served for only a short period are expected to know their segments less well than CEOs that have already spent several years in the company.. Similarly, CEOs serving on boards of several companies are likely less familiar with individual segments of these companies.²⁹ We define a firm as *high friction*, i.e. subject to high informational frictions, if CEO tenure is below the sample median or the CEO sits on a number of boards above the sample median.

Finally, to measure import competition at the 4-digit SIC industry level, we use the growth of Chinese import penetration by industry from 1999–2007 (the ‘China shock’) from Autor et al. (2013). As import penetration could be driven by unobservable industry factors, we collect data on imports from China to eight other advanced economies.³⁰ As Autor et al. (2013) show, the instrument isolates the supply component in observed imports (i.e. the variation in imports that is due to rising productivity in China and not due to observable or unobservable changes in the US economy). On aggregate, Chinese import penetration increased from 0.6% to 4.6% between 1991 and 2007.

Our final sample covers 4,202 individual firms and 7,264 individual segments. Around one-fifth of firms are multi-segment firms. The median multi-segment firm has 3 segments, with a maximum of 11. The unconditional conglomerate discount equals 16.4%; in other words, multi-segment firms’ Q is over 16% lower than that of single-segment firms. Data on imports from China is only available for firms in the manufacturing sector. In our firm-level analysis on competition we thus need to restrict the sample to manufacturing firms active between 1999 and 2007. The online appendix provides descriptive statistics.

²⁹This measure builds on the literature on limited cognitive load; see Eppler and Mengis (2004) for a survey.

³⁰Autor et al. (2013) define the growth of Chinese import penetration for industry s from 1999–2007 as $\Delta China_i = \Delta M_i / (Y_{i0} + M_{i0} - X_{i0})$, where ΔM_i is the growth in US imports from China from 1999–2007, which is divided by initial absorption (US industry shipments plus net imports, $Y_{i0} + M_{i0} - X_{i0}$) in the base period 1991, which is near the start of China’s export boom. The authors argue that rising imports from China reflect a supply shock. China’s falling prices, rising quality, and diminishing trade and tariff costs in these surging sectors are causes of its manufacturing export growth. The eight other advanced economies Australia, Denmark, Finland, Germany, Japan, New Zealand, Spain, and Switzerland. See Autor et al. (2013) for details.

5.2 Deriving testable implications

Combining the equations for capital allocation (4e) and equilibrium cutoff costs with the definition of reported marginal cost ($z_{fs}c_f = \mu_{fs}x_{fs}c_f$) yields the core set of equations at the segment level:³¹

$$\ln(c_{Dt}) = \frac{1}{2 + \rho} \left[\ln\left(\frac{\gamma\phi f_e}{\Omega L}\right) - \ln(1 + \tau_t^{-\rho}) \right] \quad (12a)$$

$$\ln(rmc_{fst}) = \ln(\mu_{fst}) - \ln(c_{Dt}) + \ln(x_{fst}) \quad (12b)$$

$$\ln(\text{assets}_{fst}) = \ln[rmc_{fst}(1 - rmc_{fst})] + 2\ln(c_{Dt}) + \ln\left(\frac{L}{2\gamma\varphi_k}\right), \quad (12c)$$

where rmc_{fst} denotes marginal costs relative to the market cutoff of segment s in firm f in year t . Equation 12a shows that a fall in trade costs implies a lower market cutoff cost. Equation 12b relates relative marginal costs to the cut-off value and over-reporting factor. Equation 12c shows how segment assets depend on the market cutoff and relative marginal costs.

Dynamics in the model are driven by three time-varying variables trade cost (τ_t), market cutoff cost (c_{Dt}), and over-reporting factors (μ_{fst}). The key channel is that falling trade costs, by lowering the cutoff value, lead to a decline in the over-reporting factor: under pressure of tougher competition, managers reduce the extent to which they over-report the cost of their division. In consequence, the allocation of assets across segments changes, as it depends on relative marginal costs.³²

We do not observe marginal costs directly in the data. However, Equation 4c shows that relative marginal costs are an inverse function of the return on assets (RoA), which we observe at the segment level. Specifically, the theory expresses variables in terms of marginal cost relative to the cutoff value, $z_{fst}c/c_{Dt}$. Rearranging, the model yields $rmc_{fst} = 1/(1 + \frac{\theta}{\varphi_k} \text{returns}_{fst})$. Here, θ is the rental price of capital on the external market and φ_k is the capital share of total cost, both of which are the same across firms and segments. We thus calculate a model-driven measure of relative marginal costs, based

³¹Equation 12a is the solution of the free entry condition (10) in an open economy, similar to Mayer et al. (2014). We report the details in the appendix.

³²Additional factors capturing market size (f_e, L), preferences (γ), and technology ($\Omega, \phi, \rho, \varphi_k$ and $x_{fs}c_f$) are constant over time. In our estimation, we include fixed effects to control for these (unobservable) variables.

on the adjusted segment RoA, as

$$\widetilde{r\text{m}c}_{fst} = \frac{1}{1 + \text{RoA}_{fst}}. \quad (13)$$

As discussed above, we adjust $\widetilde{r\text{m}c}_{fst}$ to address measurement issues and purge the measure from possibly confounding factors.³³ We denote the adjusted measure of relative marginal costs $r\text{m}c_{fst}$.

It is important to keep two potential caveats in mind. First, to the extent that our analysis exploits shocks at the industry level (i.e., the China shock), such common factors that affect firms within an industry will not invalidate our estimation – we will show the robustness of our findings to accounting for common factors in more detail below. Second, tougher competition could affect the return on assets by lowering firm or segment profits, even if marginal costs remain unaffected. If so, tougher competition would lead to a mechanical increase in measured marginal costs by reducing segments’ return on assets. However, our model predicts that more competition lowers marginal costs by reducing over-reporting. Any potential mechanical bias arising from the effect of competition on profits would thus work against our mechanism, and our estimated effects would present a lower bound. We will discuss this aspect in more detail in Section 5.3.

In what follows, we will refer to *marginal costs relative to the market cutoff* as either *relative marginal costs* or simply *marginal costs*. We now derive testable predictions from the model based on equations (12a)–(12c).

5.2.1 The conglomerate discount reflects within-firm mis-allocation

We begin by investigating the allocation of capital across firms and segments, and its relation to the conglomerate discount.

Prediction 1 *A firm’s Q is decreasing in its average marginal cost across segments and increasing in the dispersion of marginal costs across segments, conditional on average marginal costs.*

³³As we discuss in the data section, we follow De Loecker et al. (2020) to adjust marginal costs for measurement error and then regress marginal costs on confounding time-varying industry factors to eliminate potentially confounding aggregate factors. Our measure of marginal costs is the resulting residual.

Prediction 1 follows directly from Equation 11. First, higher marginal costs decrease the average return on assets and thereby Q directly. Second, a wider dispersion of marginal costs across segments makes the internal capital market's role of 'winner picking' more valuable, which increases Q . To test this relationship, we estimate the following regression at the firm-year level:

$$Q_{ft} = \beta_1 \overline{rmc}_{ft} + \beta_2 sd(rmc)_{ft} + \theta_f + \epsilon_{ft}, \quad (14)$$

where \overline{rmc} denotes average marginal costs across segments of firm f in year t , and $sd(rmc)_{ft}$ denotes the standard deviation of marginal costs across segments. Standard errors are clustered at the firm level to account for serial correlation. Equation 14 includes firm fixed effects (θ_f), which implies an interpretation in changes: it indicates how a firm's Q changes when average marginal costs or their dispersion increase. Prediction 1 suggests $\beta_1 < 0$ and $\beta_2 > 0$.

Table 1: **Tobin's Q and marginal costs**

VARIABLES	(1) Q	(2) Q	(3) Q	(4) Q
mean(marginal costs)	-0.273*** (0.027)	-0.295*** (0.025)	-0.293*** (0.026)	-0.328*** (0.033)
sd(marginal costs)		0.096*** (0.018)	0.114*** (0.017)	0.123*** (0.024)
Observations	3,290	3,290	3,290	3,290
R-squared	0.713	0.718	0.749	0.869
Firm FE	✓	✓	✓	✓
Year FE	-	-	✓	-
Industry*Year FE	-	-	-	✓

Note: The dependent variable is Tobin's Q ; *mean(marginal costs)* denotes average marginal costs across segments of firm f in year t , and *sd(marginal costs)* the standard deviation of marginal costs across segments. Standard errors are clustered at the firm level. All variables are standardized to mean zero and standard deviation of one. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 1, column (1), shows that an increase in average marginal costs is significantly correlated with a reduction in Q ($\beta_1 < 0$). Column (2) adds $sd(rmc)$ and shows that,

conditional on average marginal costs, an increase in the dispersion of marginal costs goes hand-in-hand with a significant increase in Q ($\beta_2 > 0$). To account for (unobservable) trends across firms, column (3) includes year fixed effects. Column (4) further absorbs time-varying trends at the industry level through industry*year fixed effects, thus comparing firms within the same industry and year. The coefficients keep their sign and significance, and remain similar in terms of magnitude. As all variables are standardized, coefficients in column (4) suggest that a one standard deviation increase in average marginal costs (their standard deviation) decreases (increases) Q by 0.33 (0.12) standard deviations. Table 1 thus provides evidence consistent with Prediction 1.

5.2.2 Inversely U-shaped capital allocation

Equation 12c shows that the elasticity of assets to relative marginal costs, holding cutoff cost c_D constant, is given by:

$$\left. \frac{\partial \ln(asset_{fst})}{\partial \ln(rmc_{fst})} \right|_{\ln(c_{Dt})} = \frac{1 - 2rmc_{fst}}{1 - rmc_{fst}}. \quad (15)$$

Capital allocated to a segment increases with marginal costs for low values of marginal costs, while it declines for higher values.³⁴ This results in the following prediction:

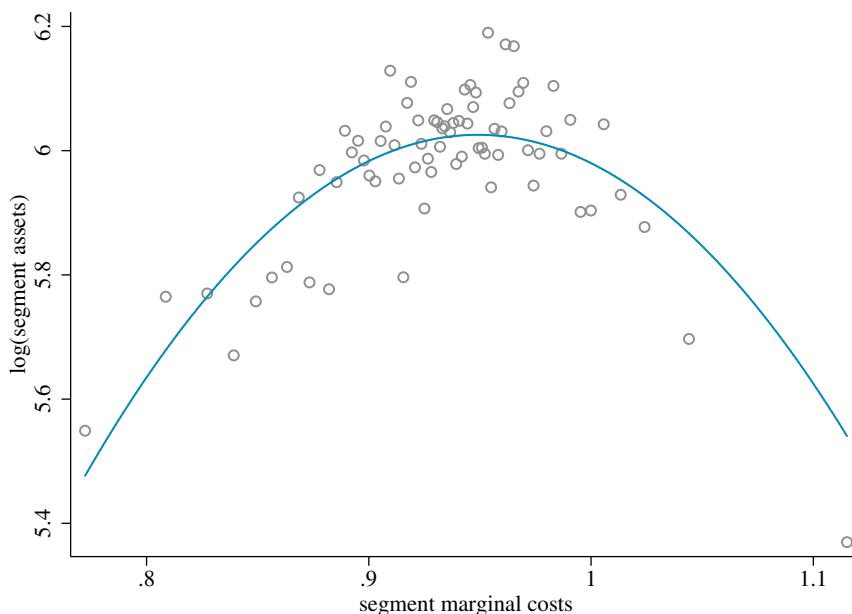
Prediction 2 *The relationship between relative marginal costs of a segment and its allocated capital follows an inverse U-shape.*

The inverse U-shape arises due to opposing forces. On the one hand, two effects lead firms to allocate more capital to a segment when marginal costs increase. First, segments with higher marginal costs require more capital, conditional on sales; we call this the *technology effect*. Second, managers over-report the true cost of their divisions to receive more funding (*over-reporting effect*). On the other hand, segments with higher marginal costs must charge higher prices and hence face lower demand (*demand effect*), and managers of segments with high marginal costs face a higher probability of not being funded at all (which limits over-reporting). Both channels decrease allocated capital. With rising marginal costs, the demand effect becomes stronger and the over-reporting

³⁴Note that the value of the turning point at 0.5 follows from our normalisation of $2\theta/\varphi_k = 1$, which is a constant that can be arbitrarily re-scaled without loss of generality.

effect weaker, so the positive association reverses.³⁵

Figure 3: **Segment capital allocation and efficiency**



Note: This figure provides a binned scatterplot of log segment assets on the y-axis against segment relative marginal costs on the x-axis, conditional on firm fixed effects. It shows that a humped-shaped relation between segment size and efficiency within a firm.

Figure 3 provides a binscatter plot of segment log assets on the y-axis against segment marginal costs on the x-axis, together with the quadratic fit (blue line). There is a clear hump-shaped pattern: for lower values of marginal costs, capital allocated to a segment increases with marginal costs, for higher values it declines. In line with Prediction 2, the pattern suggests that as we move from more to less efficient segments, the demand and over-reporting effect start to dominate the technology effect.³⁶

5.2.3 Capital allocation and informational frictions

In the model, mis-allocation within multi-segment firms arises from segment managers' desire for empire building and over-reporting, which is enabled by informational fric-

³⁵Note that the right-hand side in Equation 15 is decreasing in relative marginal costs. This implies that asset allocation is more sensitive to a change in marginal costs in segments with low marginal costs.

³⁶We test for the hump-shaped relationship formally in the Online Appendix. The hump-shaped relationship holds in specifications with firm and year fixed effects, as well as when accounting for differential industry trends over time.

tions: as the headquarters cannot verify the true marginal costs of its divisions, managers can over-report marginal costs. Theory thus predicts that the problem of capital mis-allocation is worse in firms in which divisional managers have more room for over-reporting, i.e., in firms with more severe informational frictions. The fact that there is no such incentive conflict in single-segment firms leads to the following predictions:

Prediction 3.1 *Within-firm mis-allocation: Multi-segment firms allocate more capital to their non-core segments than single-segment firms with similar marginal costs.*

Prediction 3.2 *Informational frictions: The degree to which multi-segment firms over-allocate capital to non-core segments, relative to single-segment firms with similar marginal costs, increases in informational asymmetries.*

To test Prediction 3.1, we estimate the following regression equation at the segment-year level, based on Equation 12c:

$$\begin{aligned} \log(\text{assets})_{fst} = & \gamma_1 \text{mutli segment}_f + \gamma_2 \text{rmc}_{fst} \\ & + \gamma_3 \text{mutli segment}_f \times \text{rmc}_{fst} + \zeta_f + \nu_i + \epsilon_{fst}, \end{aligned} \quad (16)$$

where $\log(\text{assets})$ is capital allocated to segment s of firm f in year t , mutli segment_f denotes a dummy that takes on a value of one if a segment is part of a multi-segment firm, and rmc_{fs} denotes the marginal cost of a firm's segment. For single-segment firms, the core segment is equivalent to the firm. To control for constant factors affecting asset allocation across firms in the same sector ($\ln\left(\frac{L}{2\gamma\varphi_k}\right)$ in Equation 12c), we include industry fixed effects ν_i . We further control for firm size through dummies for quartiles of the firm employment distribution (ζ_f); in other words, our regressions compare multi- and single-segment firms of similar sizes in the same industry. Standard errors are clustered at the firm level. We expect that, conditional on the same marginal cost, multi-segment firms allocate more assets to a segment than single-segment firms ($\gamma_3 > 0$).

Column (1) in Table 2 shows that single-segment firms with higher marginal costs are allocated less capital ($\gamma_2 < 0$) than single-segment firms with lower marginal costs. The positive and significant interaction term indicates that, conditional on the same core marginal costs, multi-segment firms allocate more capital to segments than single-segment firms ($\gamma_3 > 0$). Adding year fixed effects to account for time trends in column

Table 2: **Within-firm mis-allocation and informational frictions**

VARIABLES	(1)	(2)	(3)	(4)	(5)
	log(assets)	log(assets)	log(assets)	CEO nr boards log(assets)	CEO time log(assets)
multi-segment	-1.754*** (0.402)	-1.835*** (0.403)	-2.005*** (0.458)	-0.993** (0.430)	-0.792 (0.529)
marginal costs	-1.023*** (0.291)	-1.095*** (0.294)	-1.098*** (0.323)	-0.328 (0.395)	-0.729* (0.397)
multi-segment × marginal costs	0.885** (0.431)	0.973** (0.433)	1.173** (0.492)	-0.040 (0.471)	-0.236 (0.570)
high friction				0.610 (0.405)	0.733 (0.516)
multi-segment × high friction				-1.458*** (0.536)	-2.582*** (0.742)
marginal costs × high friction				-0.923** (0.443)	-0.825 (0.543)
multi-segment × marginal costs × high friction				1.785*** (0.587)	2.996*** (0.796)
Observations	16,982	16,982	16,982	16,982	16,982
R-squared	0.531	0.538	0.599	0.601	0.601
Firm Size	✓	✓	✓	✓	✓
Industry FE	✓	✓	-	-	-
Year FE	-	✓	-	-	-
Industry*Year FE	-	-	✓	✓	✓

Note: The dependent variable is the log of total assets at the segment-year level. *multi-segment* is a dummy with a value of one for multi-segment firms and zero for single-segment firms, *marginal costs* denotes relative marginal costs in each segment, adjusted for measurement error and purged of common factors. *low (high) friction* refer to firms below (above) the median in terms of number of boards the average CEO sits on (column 4), or below (above) the median in terms of the years the average CEO sits on the board (column 5). Standard errors are clustered at the firm level. *** p<0.01, ** p<0.05, * p<0.1

(2), or industry*year fixed effects that absorb any unobservable trends that affect all firms within the same industry in column (3), does not change this pattern. In terms of magnitude, comparing segments at the 90th to those at the 10th percentile in terms of marginal costs, multi-segment firms allocate around 19% more assets to the less efficient segment, relative to single-segment firms with similar marginal costs. Columns (1)–(3) thus provide support for the relation stated in Prediction 3.1.

In columns (4)–(5) we investigate Prediction 3.2 and the role of informational frictions. Our main measure of informational frictions is the average number of of boards the firms' CEOs sit on. The intuition is that CEOs serving on boards of several companies are less familiar with individual segments of these companies. Column (4) shows that capital mis-allocation is worse among multi-segment firms subject to more severe frictions. When we interact our main variables with a dummy *high friction* that takes on a value of one for firms whose CEOs sit on an above-median number of boards, the coefficient on the triple

interaction effect is positive and highly significant. Column (5) introduces an alternative measure of informational frictions, based on a split by the time that the average CEO spent on the board of a firm. Firms in which the average CEOs has spent comparatively little time on the board are classified as *high friction* firms; firms in which the average CEO served a relatively long time on the board are classified as *low friction*. Similar to column (4), multi-segment firms with more severe informational frictions allocate more capital to segments relative to single-segment firms with comparable marginal costs – as seen from the positive triple interaction effect, significant at the 1% level. These findings suggest that the problem of allocating too much capital to the best segments (relative to single-segment firms) is stronger for multi-segment firms in which informational frictions are more severe, supporting Prediction 3.2.

5.3 The China shock and mis-allocation within firms

In this section, we investigate how an exogenous shock to competition – rising imports from China – affects within-firm capital allocation and the conglomerate discount. In the model, tougher import competition (modeled as a decline in trade costs) reduces the cost level at which divisions can survive in the market. As managers' scope for over-reporting is constrained by c_D , competition reduces over-reporting. The incentive to over-report declines most for managers in segments with the lowest relative marginal costs, which follows directly from Proposition 1. The fall in marginal costs in the best segments, relative to worse segments, implies that there is an increase in dispersion in marginal costs across segments. Equation 11 shows that such a wider dispersion of marginal costs within firms increases multi-segment firm's Q and hence reduces the conglomerate discount, which results in the following prediction:

Prediction 4.1 *An increase in import competition reduces the conglomerate discount.*

At the segment level, tougher competition reduces the over-reporting factor μ_{fst} through its effect on the cut-off value. Specifically, the derivative of Equation 12b with respect to c_D is:

$$\frac{\partial \ln(rmc_{fst})}{\partial \ln(c_{Dt})} = \frac{\partial \ln(\mu_{fst})}{\partial \ln(c_{Dt})} - 1. \quad (17)$$

If the elasticity of μ_{fst} with respect to a change in c_D is larger than one (i.e. the change in c_{Dt} itself), Equation 17 implies that marginal costs relative to the cut-off value decline in response to competition.

Competition also affects the headquarters' allocation of capital across segments. Equation 12c shows that the overall change in asset allocation depends on the relative strength of two components: the *demand effect* and the *over-reporting effect*:

$$\underbrace{\frac{\partial \ln(\text{asset}_{fst})}{\partial \ln(c_{Dt})} \Big|_{\ln(rmc_{fst})}}_{\text{DEMAND EFFECT}} = 2 \quad (18)$$

$$\underbrace{\frac{\partial \ln(\text{asset}_{fst})}{\partial \ln(rmc_{fst})} \Big|_{\ln(c_D)}}_{\text{OVER-REPORTING EFFECT}} = \frac{1 - 2 rmc_{fst}}{1 - rmc_{fst}} \quad (19)$$

The *demand effect* captures that lower trade costs increase segment sales and thereby directly segment assets, conditional on marginal costs. The *over-reporting effect* captures the indirect effect of lower c_{Dt} through lower marginal costs on segment assets. In response to a trade shock over-reporting declines. If the elasticity of μ_{fst} with respect to a change in c_D is larger than one (see Equation 17), segment marginal costs fall, and fewer assets are allocated to the respective segment. This effect will be particularly strong for the best segments, due to the hump-shaped relationship between assets and marginal costs. The overall effect of competition on capital allocation thus depends on which effect dominates,³⁷ which yields the following predictions:

Prediction 4.2 *An increase in import competition reduces marginal costs in the best segments if the elasticity of over-reporting factor μ with respect to cutoff value c_D is greater one.*

Prediction 4.3 *An increase in import competition increases the allocation of capital to the best segments if the demand effect dominates the over-reporting effect.*

³⁷Note that the derivative of log assets with respect to log rmc (over-reporting effect) in Equation 19 is positive for $rmc \leq 0.5$ and surpasses -2 (the direct effect of c_D on log assets) only at around $rmc \geq 0.7$. This means that the over-reporting effect is expected to dominate the demand effect in the least efficient segments.

To test Prediction 4.1–Prediction 4.3 empirically, we follow Autor et al. (2013) and define ΔChina_i as the change in import penetration for four-digit SIC industry i from 1999–2007. Industries with a stronger increase in Chinese imports are subject to tougher competition. Yet, simple OLS regression could suffer from omitted variable bias or reverse causality. For example, imports from China could rise the most in industries where domestic (US) multi-segment firms are of particularly low quality. To address these concerns and isolate the supply component in observed imports, we instrument actual US imports from China with imports from China to eight other advanced economies. We will also show that our results are robust to accounting for differential effects of potentially confounding factors, such as declining interest rates.

We first investigate Prediction 4.1, i.e. the effect of competition on the conglomerate discount and estimate the following firm-level regression from 1999–2007:

$$\begin{aligned} \Delta Q_{fit} = & \delta_1 \text{multi segment}_f + \delta_2 \Delta\text{Chinese imports}_i \\ & + \delta_3 \text{multi segment}_f \times \Delta\text{Chinese imports}_i + \zeta_f + \theta_i + \tau_t + \epsilon_{fit}. \end{aligned} \tag{20}$$

The dependent variable ΔQ denotes the yearly change in the Tobin’s Q of firm f in industry i . The dummy *multi segment* takes on a value of one if firm f is a multi-segment firm, $\Delta\text{Chinese imports}_i$ denotes the (instrumented) change in Chinese imports from 1999–2007 in industry i . We control for firm size through dummies for quartiles of the firm employment distribution. To control for factors common to firms within the same industries, as well as common trends over time, we subsequently add industry and time fixed effects. All regressions cluster standard errors at the industry level, i.e. the level of the shock. The coefficient δ_1 indicates the change in conglomerate discount for the average multi-segment firm, absent any change in competition. Coefficient δ_3 indicates how Q changes for multi-segment firms in industries with a stronger increase in competition, relative to single-segment firms. Prediction 4.1 implies $\delta_3 > 0$: the conglomerate discount declines by more in industries with a stronger rise in Chinese imports.

Table 3, column (1) shows that the average Q grows faster for multi-segment firms, relative to single-segment firms (significant at the 10% level). In other words, the conglomerate discount declined over the sample period in industries with no change in imports from China. Coefficient δ_3 is positive and significant at the 1% level, indicating that the discount declines faster in industries with a stronger rise in competition. Adding in-

Table 3: **Import competition and the conglomerate discount**

VARIABLES	(1) ΔQ	(2) ΔQ	(3) ΔQ
multi-segment	0.041* (0.023)	0.031 (0.024)	0.031 (0.021)
Δ Chinese imports	-0.070 (0.164)		
multi-segment \times Δ Chinese imports	0.342*** (0.129)	0.273** (0.112)	0.242** (0.107)
Observations	2,018	2,018	2,018
Firm Size	✓	✓	✓
Industry FE	-	✓	✓
Year FE	-	-	✓

Note: The dependent variable is the yearly change in firms' Tobin's Q . *multi-segment* is a dummy with a value of one for multi-segment firms and zero for single-segment firms, Δ *Chinese imports* denotes the change in Chinese import penetration at the industry level from 1999 to 2007, instrumented with Chinese imports in 8 other advanced economies. All regression cluster standard errors at the firm level and are weighted by firm sales. The mean (sd) of the dependent variable is -0.02 (0.33). Δ *Chinese imports* has a mean (sd) of 0.11 (0.19). *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

dustry fixed effects in columns (2) and year fixed effects in column (3) does not materially affect the estimated coefficients. Note that industry fixed effects absorb the coefficient on Δ *Chinese imports*. Results thus suggest that an increase in competition reduces the conglomerate discount. In terms of magnitude, in column (3) a one standard deviation increase in Δ *Chinese imports* leads to a 4.5% increase in Q among multi-segment firms, relative to single-segment firms. In other words, the conglomerate discount narrows in response to competition. Note that coefficients in Table 3 show the differential effect of competition on Q of multi-segment firms in a given year. As the China shock spans the period from 1999 to 2007, column (3) implies a cumulative effect of competition on Q of around one-third over the eight year period.

To investigate Prediction 4.2 and Prediction 4.3, i.e., the effect of competition on the allocation of assets and marginal costs among multi-segment firms, we estimate the

following segment-level regressions for the sample of multi-segment firms only:

$$\begin{aligned} \Delta y_{fsit} = & \xi_1 \textit{efficient segment}_{fs} + \xi_2 \Delta \textit{Chinese imports}_i \\ & + \xi_3 \textit{efficient segment}_{fs} \times \Delta \textit{Chinese imports}_i + \epsilon_{fsit}, \end{aligned} \quad (21)$$

where Δy is the yearly change in marginal costs or the log of total assets of segment s belonging to firm f in segment industry i . $\Delta \textit{Chinese imports}$ is the 1999–2007 (instrumented) change in import penetration of segment industry i , *efficient segment* is a dummy that takes on a value of one if a segment has the lowest marginal costs among all segments of a firm. Each regression controls for firm size through dummies for quartiles of the firm employment distribution and for common trends through time fixed effects.

The main coefficient of interest is ξ_3 : under the assumption that the elasticity of μ with respect to c_D is larger one (Prediction 4.2), we expect that competition decreases marginal costs of better segments ($\xi_3 < 0$). For assets, the overall effect of competition depends on the relative strength of the demand vs. over-reporting effect (Prediction 4.3). If $\xi_3 > 0$, this implies that an increase in import competition increases allocated capital to the best segments and that the demand effect dominates the over-reporting effect.

The underlying friction that gives rise to mis-allocation is asymmetric information. We thus expect the disciplining effects of import competition on segment marginal costs and assets to be particularly strong within firms that are subject to stronger informational asymmetries. Similar to the firm level analysis, we classify firms into those with high and low informational frictions along the median number of boards the firms' CEOs sit on, as well as the median tenure of CEOs on the board.

Table 4 shows that rising import competition leads to a decrease in marginal costs at and an increase in allocated assets to efficient segments of multi-segment firms. Columns (1)–(4) use the change in marginal costs as dependent variable. Column (1) shows a significant relative decrease in marginal costs among better segments of multi-segment firms in response to higher competition, conditional on time trends. Adding industry fixed effects does not materially affect coefficients in column (2). Based on Prediction 4.2, the negative coefficient on the interaction term (ξ_3) suggests that the elasticity of over-reporting factor μ to a trade-induced change in cut-off value c_D is greater one.

The change in marginal costs is particularly strong for firms with more severe frictions, relative to firms with lower frictions. In column (3), high friction refers to firms with an above median number of boards their CEOs sit on; column (4) measures high-friction

firms as those with below median CEO tenure. In both columns, there is a negative and highly significant coefficient on the triple interaction effect of *efficient segment*, *Chinese imports*, and *high friction*, which shows that in response to competition, marginal costs decline by relatively more among the best segments in multi-segment firms subject to more severe informational frictions.

Table 4: **Import competition and within-firm mis-allocation**

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Δmc	Δmc	nr boards Δmc	time Δmc	$\Delta assets$	$\Delta assets$	nr boards $\Delta assets$	time $\Delta assets$
efficient segment	-0.005** (0.002)	-0.004** (0.002)	-0.008** (0.003)	-0.004* (0.002)	-0.017 (0.011)	-0.016 (0.011)	-0.042*** (0.016)	0.022* (0.012)
Δ Chinese imports	0.039*** (0.011)	0.046*** (0.011)	0.024 (0.015)	-0.016 (0.016)	-0.035 (0.054)	-0.058 (0.054)	0.031 (0.072)	-0.026 (0.077)
efficient segment \times Δ Chinese imports	-0.058*** (0.015)	-0.059*** (0.015)	-0.001 (0.021)	0.018 (0.021)	0.182** (0.074)	0.179** (0.074)	-0.142 (0.104)	-0.246** (0.103)
high friction			0.001 (0.005)	-0.015*** (0.004)			-0.055** (0.023)	-0.042** (0.017)
efficient segment \times high friction			0.005 (0.004)	-0.013*** (0.004)			0.050** (0.021)	-0.141*** (0.022)
Δ Chinese imports \times high friction			0.035 (0.027)	0.112*** (0.021)			-0.073 (0.134)	0.087 (0.102)
efficient segment \times Δ Chinese imports \times high friction			-0.120*** (0.030)	-0.130*** (0.031)			0.723*** (0.148)	1.156*** (0.150)
Observations	1,909	1,909	1,909	1,909	1,909	1,909	1,909	1,909
Firm Size	✓	✓	✓	✓	✓	✓	✓	✓
Industry FE	-	✓	✓	✓	-	✓	✓	✓
Year FE	✓	✓	✓	✓	✓	✓	✓	✓

Note: The dependent variable is the change in segment marginal costs (Δmc) or log assets ($\Delta assets$). *efficient segment* is a dummy with value one for the most-efficient segments within a firm in terms of average return on assets. Δ *Chinese imports* denotes the change in Chinese import penetration at the industry level from 1999 to 2007, instrumented with Chinese imports in 8 other advanced economies. *low (high) friction* refer to firms below (above) the median in terms of number of boards the average CEO sits on, or below (above) the median in terms of the years the average CEO sits on the board. All regression are weighted by segment sales. The mean (sd) of the dependent variable is -0.00 (0.04) for Δmc and 0.06 (0.18) for $\Delta assets$. Δ *Chinese imports* has a mean (sd) of 0.07 (0.15). *** p<0.01, ** p<0.05, * p<0.1

Columns (5)–(8) use the change in log assets as dependent variable. Column (5) shows an increase in assets allocated to better segments in response to tougher competition, indicated by the positive and significant interaction term. Adding industry fixed effects does not affect coefficients, see column (6). From Prediction 4.3 it follows that the demand effect dominates the over-reporting effect, as the coefficient on the interaction term (ξ_3) suggests is positive.

Similar to results for marginal costs, the competition-induced increase in asset allocation is particularly strong among multi-segment firms with more severe frictions. Adding interaction effects with the measures of informational friction, i.e. number of boards and tenure, in columns (7) and (8) shows that the increase in assets is more pronounced in firms in which informational frictions are higher and the scope for a reduction in over-

reporting larger.

How large is the effect of rising imports on reported marginal costs and allocated assets? For marginal costs, in column (2) of Table 4, the coefficient on the interaction term *efficient segment* \times Δ *Chinese imports* equals -0.059 . Thus, an increase in import competition by one percentage point reduces relative marginal costs of better segments by approximately 5.9%, relative to worse segments. For assets in column (6), the same increase in imports increases assets allocated to the best segments by around 17.9%.

We can use the estimated effect on marginal costs to measure the change in the over-reporting factor μ . From Equation 17 it follows that the elasticity of μ to a trade-induced change in c_D is equal to the elasticity of relative marginal cost to c_D plus one. Consequently, for a one unit increase in imports from China, segment marginal costs decline by 5.9% and the over-reporting factor by a sizeable 15.9% in efficient segments, relative to worse segments. Coming back to Prediction 4.2 and Prediction 4.3, we thus conclude that the elasticity of μ with respect to c_D is greater than one, and that the demand effect dominates the over-reporting effect.

Taken together, the results in Table 4 suggest that rising competition leads to an increase in the efficiency of the internal capital market by reducing reported marginal costs and increasing assets allocated to the best segments. The disciplining effect of competition is stronger for firms with more severe informational frictions, relative to firms with lower frictions.

5.4 Robustness

Declining interest rates Our model and empirical results show how tougher import competition – measured through rising imports from China – reduce capital mis-allocation within firms. Yet, a potentially confounding factor could be declining interest rates, which have been linked to capital mis-allocation as well. For example, Gopinath et al. (2017) argue that lower interest rates in South Europe after the introduction of the Euro have increased mis-allocation of capital between firms. In our model, a lower interest rate could lead to the financing of a worse pool of segments and conglomerate firms, as firms finance segments with higher levels of over-reporting (result available on request). To account for this possibly confounding factor, in Table 5 we estimate Equation 21, but directly control for interest rates and their differential effect on assets and marginal costs of efficient segments. Specifically, we use Compustat data on the average interest expense

over total debt for each 4-digit industry to proxy the evolution of financing costs among firms in each industry.

Table 5: **Accounting for the cost of external financing**

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)
	Δ assets	nr boards Δ assets	time Δ assets	Δ mc	nr boards Δ mc	time Δ mc
efficient segment	-0.084*** (0.020)	-0.102*** (0.021)	-0.057*** (0.020)	-0.007* (0.004)	-0.008* (0.004)	-0.002 (0.004)
Δ Chinese imports	-0.080 (0.054)	0.016 (0.072)	-0.038 (0.077)	0.045*** (0.011)	0.024 (0.015)	-0.017 (0.016)
efficient segment \times Δ Chinese imports	0.233*** (0.075)	-0.129 (0.104)	-0.215** (0.103)	-0.057*** (0.015)	-0.001 (0.021)	0.018 (0.021)
high friction		-0.053** (0.023)	-0.042** (0.017)		0.001 (0.005)	-0.016*** (0.004)
efficient segment \times high friction		0.032 (0.021)	-0.129*** (0.022)		0.005 (0.004)	-0.015*** (0.004)
Δ Chinese imports \times high friction		-0.072 (0.133)	0.078 (0.101)		0.035 (0.027)	0.114*** (0.021)
efficient segment \times Δ Chinese imports \times high friction		0.806*** (0.149)	1.214*** (0.150)		-0.119*** (0.030)	-0.128*** (0.031)
interest expense	2.078 (1.306)	2.050 (1.297)	0.432 (1.284)	-0.556** (0.266)	-0.516* (0.265)	-0.708*** (0.263)
efficient segment \times interest expense	4.519*** (1.089)	4.660*** (1.101)	5.129*** (1.072)	0.180 (0.222)	0.078 (0.225)	-0.080 (0.220)
Observations	1,909	1,909	1,909	1,909	1,909	1,909
Firm Size	✓	✓	✓	✓	✓	✓
Industry FE	✓	✓	✓	✓	✓	✓
Year FE	✓	✓	✓	✓	✓	✓

Note: The dependent variable is the change in segment log assets ($\Delta assets$) or marginal costs (Δmc). *efficient segment* is a dummy with value one for the most-efficient segments within a firm in terms of average return on assets. Δ *Chinese imports* denotes the change in Chinese import penetration at the industry level from 1999 to 2007, instrumented with Chinese imports in 8 other advanced economies. All regression are weighted by segment sales. *low (high) friction* refer to firms below (above) the median in terms of number of boards the average CEO sits on, or below (above) the median in terms of the years the average CEO sits on the board. *** p<0.01, ** p<0.05, * p<0.1

Columns (1)–(3) use the change in segment-level assets as dependent variable, columns (4)–(6) the change in marginal costs. Results show that accounting for the effect of changes in industry-level financing costs does not materially affect our results: tougher competition leads to a relative increase (decrease) in assets (marginal costs) among efficient segments. Investigating effects among firms with higher informational frictions, measured by the number of boards the average CEO sits on or the time the CEO spent in the company (columns 2–3 and 5–6) again shows that controlling for interest rates does not affect our main conclusion: effects of tougher competition on assets and marginal costs are generally stronger among firms with more severe informational frictions.

In the online appendix, we further control for the average wage in each industry (provided by the NBER manufacturing data base), which in the model corresponds to

the guaranteed compensation of divisional managers determined in the outside market. Holding sectoral wages constant does not change our results.

Table 6: **Cost-cutting innovation**

VARIABLES	(1)	(2)	(3)
	SS firms Δmc	SS firms nr boards Δmc	SS firms time Δmc
Δ Chinese imports	0.053 (0.100)	0.059 (0.110)	0.074 (0.098)
high friction		0.005 (0.006)	-0.010 (0.011)
Δ Chinese imports \times high friction		-0.053 (0.074)	-0.082 (0.108)
Observations	938	938	938
Firm Size	✓	✓	✓
Industry FE	✓	✓	✓
Year FE	✓	✓	✓

Note: The dependent variable is the change in single-segment firms' marginal costs (Δmc). Δ *Chinese imports* denotes the change in Chinese import penetration at the industry level from 1999 to 2007, instrumented with Chinese imports in 8 other advanced economies. *low (high) friction* refer to firms below (above) the median in terms of number of boards the average CEO sits on, or below (above) the median in terms of the years the average CEO sits on the board. All regression are weighted by firm sales, standard errors are clustered at the firm level. *** p<0.01, ** p<0.05, * p<0.1

Cost-cutting innovation Our model suggests that firms' marginal costs decline in response to tougher competition because competition disciplines managers' over-reporting. Yet, firms could also be investing in cost reducing innovation in response to more competition. However, such an effect should also be present among single-segment firms that are exposed to competition – but not subject to informational frictions that enable over-reporting and capital mis-allocation. We thus estimate a placebo regression in Table 6, in which we focus on the effect of import competition on marginal costs of single-segment firms. If cost cutting innovation in response to competition is an important factor, we would expect that marginal cost decline also in single-segment firms when imports from

China increase. Instead, column (1) shows that there is no economically or statistically significant effect of import competition on marginal costs of single-segment firms. Columns (2)–(3) confirm this finding when we look at single-segment firms with CEOs on more boards or CEOs that have been in the company for a shorter period, i.e. those firms with more severe informational frictions. In conclusion, marginal costs do not respond in single-segment firms to more competition from China. This finding provides support for our mechanism that rising competition reduces marginal costs among multi-segment firms by reducing managers’ scope for over-reporting. Note that these findings are also consistent with Dorn et al. (2020) who show that the Chinese competition shock reduced investment in innovative activity and R&D expenditure among US firms.

6 Conclusion

This paper embeds an internal capital market into a model of multi-product firms with monopolistic competition. Mis-allocation arises from the empire building motive of divisional managers in firms, which compete for internal capital and overstate their divisions’ true costs to receive more funds. The best divisions in each firm end up getting “too much” capital, and stronger information asymmetries between firm owners and managers are responsible for such mis-allocation.

By embedding the internal capital market in a theory of multi-product firms, the model can provide new insights on the sources of mis-allocation of resources *within* firms and how it can lead to a conglomerate discount. Importantly, the model shows how fiercer competition can discipline managers, improve the efficiency of firms’ internal capital market, and reduce the conglomerate discount. We find support for the models’ key predictions in a sample of publicly listed US firms.

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Appendix: For Online Publication

7 Appendix A

This appendix outlines definitions and proofs stated in Section 3.

7.1 Private benefit

A manager at a firm with core marginal cost c endowed with true customization cost x_i and reporting a customization cost z_i runs production according with the technology (3) given the allocation of labor and capital $l(z_i c)$ and $k(z_i c)$, from (4d) and (4e) respectively, and a total factor productivity $(x_i c)^{-1}$ instead of $(z_i c)^{-1}$. This yields output equal to $\frac{z_i}{x_i} y(z_i c)$. The division sells $q(z_i c) = y(z_i c)$ units in the market. Thus, defining the private benefit as the excess of output capacity $\frac{z_i}{x_i} y(z_i c) - q(z_i c)$ yields:

$$b(\mu; x_i, c, c_D) = \frac{L}{2\gamma} (\mu - 1) (c_D - \mu x_i c) .$$

The private benefit is null at $\mu = 1$, it is positive for $\mu < \frac{c_D}{x_i c}$ and it has a maximum at $\bar{\mu} \equiv \frac{1}{2} \left(1 + \frac{c_D}{x_i c} \right)$ as shown by the first and second order derivatives:

$$\frac{\partial b}{\partial \mu} = \frac{L}{2\gamma} (c_D + x_i c - 2\mu x_i c) \quad \frac{\partial^2 b}{\partial^2 \mu} = -\frac{L}{\gamma} x_i c < 0 .$$

Indeed, $\frac{\partial b}{\partial \mu} > 0$ for every $\mu < \bar{\mu}$. This is without loss of generality, since it would never be optimal a factor of mis-reporting that exceeds $\bar{\mu}$, nor that is equal to $\bar{\mu}$ since the manager maximises the expected payoff and the probability of being financed is decreasing in the factor of mis-reporting.

The comparative statics of the equilibrium are robust to a more general definition of private benefit:

Definition. *Manager's private benefit is additional welfare represented by any continuous and twice differentiable function $b(\mu; x_i, c, c_D)$ with the same qualitative comparative statics as the excess of output capacity:*

$$\begin{aligned} b(1) = 0 \quad \frac{\partial b}{\partial \mu} > 0 \quad \frac{\partial^2 b}{\partial^2 \mu} < 0 , \\ \frac{\partial^2 \ln(b)}{\partial \mu \partial x_i} < 0 \quad \frac{\partial^2 \ln(b)}{\partial \mu \partial c} < 0 \quad \frac{\partial^2 \ln(b)}{\partial \mu \partial c_D} > 0 , \end{aligned} \tag{22}$$

where $\mu = z_i/x_i$ is the factor of mis-reporting.

While the first line of the comparative statics are trivial to assess, the second line refers to the log transformation of the excess of output capacity:

$$\frac{\partial \ln(b)}{\partial \mu} = \frac{1}{\mu - 1} - \frac{1}{\frac{c_D}{x_i c} - \mu}$$

which is decreasing in $x_i c/c_D$. As it can be verified in the following proof of Proposition 1, the general definition of private benefit (22) provides the sufficient conditions for a determination of the equilibrium. ■

7.2 Probability of being financed

This paragraph proves the Lemma and its result (8).

Let $F(z|m)$ be the probability that $z_i \leq z$ among managers that compete for m positions. The probability of m independent events $z_i \leq z$ conditional on $z_i \leq \bar{z}(c, c_D)$ is $\left(\frac{F(z|m)}{F(\bar{z}(c, c_D)|m)}\right)^m$. The complement at 1 is the probability that a manager in the pool of those competing for m positions at a firm with core marginal cost c and offering z is financed:

$$\psi(\mu; x_i, c, m, c_D) = 1 - \left(\frac{F(\mu x_i|m)}{F(\bar{z}(c, c_D)|m)}\right)^m \quad (23)$$

Taking the first order derivative yields:

$$\frac{\partial \psi}{\partial \mu} = -m \left(\frac{F(\mu x_i|m)}{F(\bar{z}(c, c_D)|m)}\right)^m \frac{dF(\mu x_i|m)}{dz} \frac{x_i}{F(\mu x_i|m)} < 0, \quad (24)$$

where the number of non-core divisions is $m \geq 1$, thus $\frac{\partial^2 \psi}{\partial^2 \mu} \leq 0$ for every convex c.d.f. $F(z)$. Thus, ψ is decreasing in μ and in x_i for every convex c.d.f. $F(z)$, decreasing in c and increasing in c_D , as implied by $\frac{\partial \bar{z}(c, c_D)}{\partial c} < 0$ and $\frac{\partial \bar{z}(c, c_D)}{\partial c_D} > 0$.

The comparative statics of the probability of being financed with respect to μ , x_i , c , and c_D are proved. For the dependence with respect to the number of non-core divisions the assumption of no economies of scope is necessary.

For a given managerial compensation scheme, the expected value to the firm from a non-core division in a MSF with core marginal cost c opening m divisions given a market cutoff c_D is:

$$\bar{v}_{nc}(m, c, c_D) = \int_1^{\bar{z}(c, c_D)} [(1 - \eta)\pi(zc) - f_M] \frac{mF(z|m)^{m-1}}{F(\bar{z}(c, c_D)|m)^m} dF(z|m). \quad (25)$$

For every exogenous c.d.f. $F(z)$ and every arbitrary number of non-core divisions $m = 1, 2, \dots$, a necessary and sufficient condition to rule out economies of scope is that $m\bar{v}_{nc}(m, c, c_D)$ does not depend on m .

In order to simplify the exposition while determining the implications of that assumption for the conditional distribution of customisaztion costs, call $\Gamma(a, m) \equiv m \int_1^a [(1 - \eta)\pi(zc) - f_M] \frac{mF(z|m)^{m-1}}{F(\bar{z}|m)^m} dF(z|m)$. Then, because of no economies of scope, we want $\frac{\partial \Gamma(a, m)}{\partial m} = 0 \forall a$ which implies $\frac{\partial^2 \Gamma(a, m)}{\partial m \partial a} = 0 \forall a$. Computing the first order derivative

$$\frac{\partial \Gamma(a, m)}{\partial a} = m[(1 - \eta)\pi(ac) - f_M] \frac{mF(a|m)^{m-1}}{F(\bar{z}|m)^m} dF(a|m) ,$$

shows that the second order cross derivative is null if and only if

$$\frac{\partial^2 \Gamma(a, m)}{\partial m \partial a} = 0 \iff \frac{\partial}{\partial m} \left(m \frac{mF(a|m)^{m-1}}{F(\bar{z}|m)^m} dF(a|m) \right) = 0 \forall a.$$

This is true if and only if the conditional density implied by m independent draws from the exogenous distribution $F(z)$ truncated at \bar{z} given the number of non-core divisions is equal to the marginal density of the exogenous distribution $F(z)$ truncated at \bar{z} unconditional on the number of divisions:³⁸

$$m \frac{mF(a|m)^{m-1}}{F(\bar{z}|m)^m} dF(a|m) = \frac{dF(a)}{F(\bar{z})} .$$

Integrating both sides of the differential equation over the support $a \leq 1$ and over the support $a \leq \bar{a}$ for any arbitrary $\bar{a} \in [1, \bar{z}]$ yields respectively

$$\begin{aligned} \left(\frac{F(1|m)}{F(\bar{z}|m)} \right)^m &= \frac{1}{m} \frac{F(1)}{F(\bar{z})} \\ \left(\frac{F(\bar{a}|m)^m - F(1|m)^m}{F(\bar{z}|m)^m} \right) &= \frac{1}{m} \left(\frac{F(\bar{a}) - F(1)}{F(\bar{z})} \right) . \end{aligned}$$

The system of the two conditions yields:

$$\frac{F(\bar{a}|m)}{F(\bar{z}|m)} = \left(\frac{F(\bar{a})}{mF(\bar{z})} \right)^{\frac{1}{m}} \quad \forall \bar{a} \in [1, \bar{z}].$$

Now, applying this result to our problem shows that there are no economies of scope for every arbitrary firm and market conditions (i.e. for every c and c_D) if and only if:

$$\frac{F(z|m)}{F(\bar{z}(c, c_D)|m)} = \left(\frac{F(z)}{mF(\bar{z}(c, c_D))} \right)^{\frac{1}{m}} , \quad \forall z < \bar{z}(c, c_D) . \quad (26)$$

³⁸To see this it is sufficient to substitute for $m = 1$ in the left hand side and then recall that the result must be the same for every arbitrary number m .

Substituting for (26) in (23) yields:

$$\begin{aligned}\psi(\mu; x_i, c, m, c_D) &= 1 - \frac{F(\mu x_i)}{mF(\bar{z}(c, c_D))} \\ \frac{\partial \psi}{\partial \mu} &= -\frac{x_i}{mF(\bar{z}(c, c_D))} \frac{dF(\mu x_i)}{dz} < 0.\end{aligned}$$

Thus, the probability of being financed is increasing in non-core divisions m . ■

Before proceeding with the proof of Proposition 1, we show that the characterization of the probability of being financed implies an expected profit from non-core divisions that is equal to the average profit of a non-core segment. Rearranging (26) yields:

$$\frac{F(z|m)}{F(\bar{z}(c, c_D)|m)} = \left(\frac{F(z)}{mF(\bar{z}(c, c_D))} \right)^{\frac{1}{m}} \quad \frac{dF(z|m)}{F(z|m)} = \frac{dF(z)}{mF(z)}, \quad \forall z < \bar{z}(c, c_D).$$

Substituting in (25) yields the expected value to the firm from m non-core divisions:

$$m\bar{v}_{nc}(c, m, c_D) = \int_1^{\bar{z}(c, c_D)} \frac{[(1-\eta)\pi(zc) - f_M]dF(z)}{F(\bar{z}(c, c_D))}, \quad (27)$$

which does not depend on the actual number of non-core divisions m . ■

7.3 Proof of Proposition 1

As announced in the main body of the paper, we conduct the proof allowing for an arbitrary share of profit $\eta \in [0, 1]$. This is redundant in equilibrium, since MSFs would optimally set $\eta = 0$, but it is instructive to show how pecuniary incentives affect managers' behavior. The proof is organized in four lemmas and then the main statement of the proposition.

Individual welfare (2) is linear in income, thus, the pecuniary incentive of a profit share adds to the private benefit. This modifies the manager's expected payoff, which is now given by the private benefit plus the share of profit. The manager's problem (9) that is now replaced by:

$$\mu_i^* = \arg \max_{\mu \geq 1} \psi(\mu; x_i, c, c_D, m) [b(\mu; x_i, c, c_D) + \eta\pi(\mu x_i c)], \quad (28)$$

The manager's problem (28) has a unique solution, which is characterized by the following generalization of Proposition 1:

Generalization of Proposition 1. *Better managers, i.e. those characterized by $1 \leq x_i < \frac{c_D}{2c}$, over-report the customization cost $\mu_i^*(\eta; x_i, c, m, c_D) > 1$, and the comparative statics describing their optimal decision are such that:*

- (1.1) μ_i^* is decreasing in the true customization cost of the division x_i
- (1.2) μ_i^* is decreasing in the core competence cost of the firm c
- (1.3) μ_i^* is increasing in the number of non-core divisions m
- (1.4) μ_i^* is increasing in the market cutoff cost c_D
- (1.5) μ_i^* is decreasing in the share of profit paid to the manager η

instead, worse managers, i.e. those characterized by $\frac{c_D}{2c} \leq x_i < \frac{c_M(c_D)}{c}$, report the effective customization cost.

Clearly, the Generalization of Proposition 1 coincides with Proposition 1 but for the comparative statics (1.5) on the profit share.

The characterization of a manager's private benefit (22) is sufficient to prove the following result:

Lemma 1.1. *The semi-elasticity $\xi_b(\mu) \equiv \frac{\partial b / \partial \mu}{b}$ goes to infinity at $\mu = 1$, is decreasing in μ , x_i , c and is increasing in c_D .*

Proof. The semi-elasticity $\frac{\partial b / \partial \mu}{b}$ is decreasing in μ , since $\frac{\partial^2 b}{\partial^2 \mu} < 0$ at the numerator and $\frac{\partial b}{\partial \mu} > 0$ at the denominator. For $\mu = 1$ the semi-elasticity goes to infinity, as $b(1) = 0$ while $\frac{\partial b(1)}{\partial \mu}$ is positive and finite. To determine the comparative statics with respect to x_i , c and c_D we must look at the functional form of the semi-elasticity as implied by the excess of output capacity:

$$\xi_b(\mu) \equiv \frac{d \ln(b(\mu))}{d\mu} = \frac{\partial b / \partial \mu}{b} = \frac{1 + \frac{x_i c}{c_D} - 2\mu \frac{x_i c}{c_D}}{\mu \left(1 + \frac{x_i c}{c_D}\right) - \mu^2 \frac{x_i c}{c_D} - 1}.$$

It is sufficient taking the derivative with respect to $x_i c / c_D$ to conclude that the semi-elasticity ξ_b is decreasing in x_i and c while it is increasing in c_D . ■

The characterization of the probability to be financed (8) is sufficient to prove the following result:

Lemma 1.2. *The semi-elasticity $\xi_\psi(\mu) \equiv -\frac{\partial \psi / \partial \mu}{\psi}$ takes a positive but finite value at $\mu = 1$, it is increasing in μ , x_i and c while it is decreasing in c_D and m .*

Proof. The semi-elasticity $-\frac{\partial \psi / \partial \mu}{\psi}$ is increasing in μ , as implied by $-\frac{\partial^2 \psi}{\partial^2 \mu} < 0$ at the

numerator and $\frac{\partial\psi}{\partial\mu} < 0$ at the denominator.

The semi-elasticity is given by:

$$\xi_\psi(\mu) \equiv -\frac{\partial\psi/\partial\mu}{\psi(\mu; x_i, c, m, c_D)} = \frac{x_i}{mF(\bar{z}(c, c_D)) - F(\mu x_i)} \frac{dF(\mu x_i)}{dz},$$

which is increasing in μ and in x_i for every exogenous convex c.d.f. $F(z)$, increasing in c and decreasing in c_D , as implied by $\frac{\partial\bar{z}(c, c_D)}{\partial c} < 0$ and $\frac{\partial\bar{z}(c, c_D)}{\partial c_D} > 0$, and it is decreasing in the number of non-core divisions m . Since $x_i > 1$ and $F(x_i) < mF(\bar{z}(c, c_D))$ then both $\psi(1)$ and $-\frac{\partial\psi(1)}{\partial\mu}$ are positive and finite values. Thus, the semi-elasticity $-\frac{\partial\psi/\partial\mu}{\psi}$ takes a positive but finite value for $\mu = 1$ for every number $m = 1, 2, \dots$ of non-core divisions. ■

Lemma 1.3. *The semi-elasticity of the manager's payoff $\xi_{pay}(\mu)$ goes to infinity at $\mu = 1$, is decreasing in μ , x_i , c , η and is increasing in c_D .*

Proof. Given the equilibrium profit (4f), the semi-elasticity of profit with respect to the factor of mis-reporting is

$$\xi_\pi(\mu) \equiv \frac{\partial\pi/\partial\mu}{\pi} = -\frac{2\frac{x_i c}{c_D}}{1 - \mu\frac{x_i c}{c_D}} < 0.$$

Thus, $\xi_\pi(\mu)$ is negative, decreasing in $\frac{x_i c}{c_D}$ which is the same comparative static as for $\xi_b(\mu)$. The semi-elasticity of manager's payoff is a convex combination of the semi-elasticity of the private benefit and of profit:

$$\xi_{pay}(\mu) \equiv \xi_b(\mu)(1 - \omega(\mu, \eta)) + \omega(\mu, \eta)$$

where the weight of profit in the manager's payoff

$$\omega(\mu, \eta) \equiv \frac{\eta\pi}{b + \eta\pi} = \frac{\eta(c_D - \mu x_i c)}{2(\mu - 1) + \eta(c_D - \mu x_i c)},$$

is increasing in η and c_D , decreasing in μ , x_i and c , which are the same signs than the comparative statics for $\xi_b(\mu)$.

Since $\xi_\pi(\mu) < 0$ the semi-elasticity of manager's payoff with respect to the factor of mis-reporting is lower or equal to the semi-elasticity of manager's private benefit

$$\xi_{pay}(\mu) \equiv \xi_b(\mu)(1 - \omega(\mu, \eta)) + \omega(\mu, \eta)\xi_\pi(\mu) \leq \xi_b(\mu).$$

Since $\xi_{pay}(\mu)$ corresponds to $\xi_b(\mu)$ if and only if $\eta = 0$, then, everything else being constant, $\xi_\pi(\mu) \leq \xi_b(\mu)$ and $\xi_{pay}(\mu)$ is a decreasing function of η . The comparative statics with respect to x_i , c and c_D are affected by the introduction of a profit share. However, changes in $\xi_\pi(\mu)$ are of the same sign as changes in $\xi_b(\mu)$. And the same is true for $\xi_{pay}(\mu)$ being a convex combination of two functions both decreasing in x_i , c , and

increasing in c_D .

We now turn to study $\xi_{pay}(\mu)$. Consider $\mu = 1$, then $\xi_b(1) \rightarrow \infty$ while $\xi_\pi(1)$ is negative, but finite. This implies $\xi_{pay}(1) \rightarrow \infty$. For $\mu > 1$ but such that it satisfies profitability condition $\mu x_i c < c_D$, the positive elasticity $\xi_b(\mu)$ falls and $\xi_\pi(\mu)$ becomes even more negative, such that the convex combination $\xi_{pay}(\mu)$ has to be decreasing for every $\mu \geq 1$. Although mathematically possible, there is no need to consider the case in which $\xi_{pay}(\mu) < 0$ because it is not in the interest of the manager to over-report so much to overcome the arg max of the payoff function, corresponding to a semi-elasticity equal to zero. ■

Lemma 1.4. *Only managers with a sufficiently good know-how such that*

$$1 \leq x_i < \frac{c_D}{2c} \quad (29)$$

are capable to extract a private benefit in a firm with core marginal cost c when the market cutoff is c_D .

Proof. The equilibrium allocation of capital (4e) shows that $k(z_i c) > k(x_i c)$ if and only if:

$$(c_D - z_i c) z_i c < (c_D - x_i c) x_i c \iff \frac{(\mu + 1)(\mu - 1)}{\mu - 1} < \frac{c_D}{x_i c} \iff \mu < \frac{c_D}{x_i c} - 1 .$$

Since $b(\mu) \geq 0 \iff \mu \geq 1$, then a necessary condition for both $b(\mu) \geq 0$ and $k(z_i c) > k(x_i c)$ is

$$\frac{x_i c}{c_D} < \frac{1}{2} .$$

We call *better managers* those capable of an effective customization cost x_i that satisfies (29). We distinguish them from *worse managers*, endowed with a higher but profitable customization cost $\frac{c_D}{2c} \leq x_i < \frac{c_M(c_D)}{c}$, who are still suitable to run a division at the firm, but they cannot both engage in cost over-reporting $\mu_i > 1$ and managing more capital $k(z_i c) > k(x_i c)$. ■

Proof of Proposition 1. The first order condition of the manager's problem (9) is necessary and sufficient for an interior solution:

$$\xi_{pay}(\mu) - \xi_\psi(\mu) = 0 ,$$

since $\xi_{pay}(\mu)$ is decreasing in μ by Lemma 1.1 and 1.3, while $\xi_\psi(\mu)$ is increasing in μ , by Lemma 1.2. An interior solution of the first order condition exists, it is unique and belongs to the segment $\mu > 1$, as it satisfies the intersection $\xi_{pay}(\mu) = \xi_\psi(\mu)$, where we

have already established that $\xi_{pay}(1) > \xi_\psi(1)$.³⁹

Lemma 1.4 has shown that only better managers gain a private benefit when they over-report, i.e. $\mu > 1$. The comparative statics of the solution $\mu_i^*(\eta, x_i, c, m, c_D)$ are unambiguously understood from the comparative statics of the two semi-elasticities $\xi_{pay}(\mu)$ and $\xi_\psi(\mu)$, discussed in the previous lemmas.

We have established that $\xi_{pay}(\mu)$ is a decreasing function of η for every $\mu \geq 1$, whereas $\xi_{psi}(\mu)$ does not depend on η . It follows the unique interior solution to the manager's problem (28) describes the optimal factor of over-reporting $\mu > 1$ as a decreasing function of the profit share η . The remaining comparative statics are discussed in the graphical analysis of figures (2a) and (2b).

Worse managers do not gain a strictly positive benefit. By over-reporting they would reduce both the probability of being financed and the profit of the division. Moreover, they do not under-report because that would lead to miss the targets, hence to a prohibitive punishment. Thus, for worse managers the only feasible solution is $\mu = 1$. ■

7.4 Drivers of market competition in open economy

The model allows for a tractable analysis of several drivers of market competition in open economy, which are outlined in the following result:

Proposition 2. *The toughness of market competition, measured by a lower cutoff cost c_D , is*

(3.1) *weaker the greater the trade barriers $\frac{\partial c_D}{\partial \tau} > 0$*

(3.2) *stronger the greater the market size $\frac{\partial c_D}{\partial L} < 0$*

(3.3) *weaker the greater the taste for differentiation $\frac{\partial c_D}{\partial \gamma} > 0$*

(3.4) *weaker the greater the cost of a new entrepreneurial activity $\frac{\partial c_D}{\partial f_E} > 0$*

(3.5) *stronger the more concentrated the distribution of technology $\frac{\partial c_D}{\partial \rho} < 0$*

The proof of Proposition 2 is organized in four steps. First, we determine the expected value of the core segment from sales in the domestic market. Second, we determine the expected value of non-core segments from sales in the domestic market. Third, we determine the expected value of a firm in open economy, thus, accounting for sales in both the domestic and the foreign market; this allows us to solve for the free entry condition

³⁹The two curves need not be characterized by the concavity and convexity as shown in the Figure 2, since they would depend on the specific choice of private benefit function $b(\mu)$ and c.d.f. $F(z)$. However, for a private benefit function $b(\mu)$ and c.d.f. $F(z)$, the increasing and decreasing patterns are as drawn, and the marginal gain in expected payoff is higher than the marginal loss in the probability to be financed evaluated at $\mu = 1$.

(10) in closed form.⁴⁰ Finally, we exploit the comparative statics on expected value before entry to prove the comparative statics on the cutoff cost.

We prove a more general version of Proposition 2, which extends the main results in two directions. First, as we did for Proposition 1, we conduct the proof allowing for an arbitrary share of profit $\eta \in [0, 1]$. We show that this is redundant since the expected gross profit from non-core divisions does not depend on the profit share, hence MSFs would optimally set $\eta = 0$. Second, we derive the results in open economy allowing for a fixed cost of exporting at the segment level $f_X \geq 0$. This extends the results presented in the main body of the paper.

Core segment. In closed economy, the expected value from sales of the core segment when the market cutoff is c_D unconditional on making a successful entry is:

$$\tilde{\pi} = \int_0^{c_D} \frac{L}{4\gamma} (c_D - c)^2 dG(c)$$

Listing the parameters and taking a first order derivative yields:

$$\frac{\partial \tilde{\pi}}{\partial c_D} > 0 \quad \frac{\partial \tilde{\pi}}{\partial L} > 0 \quad \frac{\partial \tilde{\pi}}{\partial \gamma} < 0 .$$

Non-core segment. The expected value to the firm from non-core divisions is computed on the probability density of the event $m = 1, 2, \dots$ *non-core divisions are financed when the maximum customization cost for a profitable division at the firm is $\bar{z}(c, c_D)$* . This is given by the complement of the probability that a manager with reported cost z is still financed at the firm (23), which is what we called $(F(z|m)/F(\bar{z}(c, c_D)|m))^m$ in the proof of the Lemma. The expected value from $m = 1, 2, \dots$ non-core divisions to a firm with core competence cost c that offer a share of profit $\eta \in [0, 1]$ when the market cutoff is c_D is defined as

$$m \left(\int_1^{\bar{z}(c, c_D)} [(1 - \eta)\pi(zc) - f_M] \left(\frac{F(z|m)}{F(\bar{z}(c, c_D)|m)} \right)^m \frac{dF(z|m)}{F(z|m)} \right) ,$$

which, substituting for $(F(z|m)/F(\bar{z}(c, c_D)|m))^m = F(z)/[mF(\bar{z}(c, c_D))]$ as implied by (8), yields

$$\int_1^{\bar{z}(c, c_D)} \frac{[(1 - \eta)\pi(zc) - f_M] dF(z)}{F(\bar{z}(c, c_D))} ,$$

⁴⁰In the solution of the free entry condition we generalize existing frameworks (such as Melitz and Ottaviano, 2008 or Mayer et al., 2014) to account for the presence of a fixed cost, which in our model corresponds to the managerial compensation.

which is the expected value from $m = 1, 2, \dots$ non-core divisions of a MSF with maximum customization cost for a profitable division $\bar{z}(c, c_D)$.

Corollary. *By offering a profit share $\eta > 0$ the firm does not improve on the expected profit from non-core divisions.*

Proof. Consider the tournament among applicants to a firm with core competence cost c hiring $m = 1, 2, \dots$ divisional managers when the market cutoff is c_D . The firm meets with arbitrarily many managers reporting their customization costs independently. This implies that the reported customization cost by a single manager does not affect the distribution of reported customization costs faced by the firm and other applicants.

Both the MSF and candidate managers know that after the tournament, the reported customization cost in each non-core division will be a random draw from the conditional distribution $F(z)/[mF(\bar{z}(c, c_D))]$, which does not depend on the share of profit η . Therefore, a MSF cannot improve in the expected value from non-core divisions by offering $\eta > 0$. Instead, any positive profit share would decrease the expected value to the firm from non-core divisions. Thus, the optimal choice by a MSF is to offer $\eta = 0$, and this is understood by both firms and managers. ■

Based on the previous result, the expected value to the firm from financing a fringe of non-core divisions (27) is given by:

$$\int_1^{\bar{z}(c, c_D)} \frac{[\pi(zc) - f_M]dF(z)}{F(\bar{z}(c, c_D))} .$$

The probability density $\pi(zc)dF(z)/F(\bar{z}(c, c_D))$ has a mass point at the lower extreme of the support $z = 1$. Therefore, the expected value to the firm from a fringe of non-core divisions is given by:

$$\frac{[\pi(c) - f_M]F(1)}{F(\bar{z}(c, c_D))} + \int_{1+}^{\bar{z}(c, c_D)} \frac{[\pi(zc) - f_M]dF(z)}{F(\bar{z}(c, c_D))} .$$

A firm with $c \leq c_M(c_D)$ meets randomly with managers, and with a probability $F(\bar{z}(c, c_D))$ matches managers with profitable projects. Thus, the *ex-ante* expected value from non-core divisions unconditional on making a successful turn into a MSF is given by:

$$\pi^{nc}(c) = \pi(c)F(1) + \int_{1+}^{\bar{z}(c, c_D)} \pi(zc)dF(z) - F(\bar{z}(c, c_D))f_M .$$

Corollary. *The comparative statics on the ex-ante expected value of non-core divisions*

$\tilde{\pi}^{nc}(c)$ are:

$$\frac{\partial \pi^{nc}(c)}{\partial c} < 0 \quad \frac{\partial \pi^{nc}(c)}{\partial c_D} > 0 \quad \frac{\partial \pi^{nc}(c)}{\partial L} > 0 \quad \frac{\partial \pi^{nc}(c)}{\partial \gamma} < 0 .$$

Proof. To the purpose of facilitating the analysis of comparative statics, define the vector of parameters $\chi = \{c, c_D, L, \gamma\}$, and change the notation as follows $\pi(z; \chi) \equiv \pi(zc)$ and $\bar{z}(\chi) \equiv \bar{z}(c, c_D)$. The ex-ante expected value from non-core divisions in a firm with core competence cost c is given by:

$$\pi^{nc}(c) = \pi(1; \chi)F(1) + \int_{1+}^{\bar{z}(\chi)} \pi(z; \chi)dF(z) - F(\bar{z}(\chi))f_M .$$

Moreover, notice that $\pi(\bar{z}(\chi); \chi) = f_M$ by definition of $\bar{z}(\chi)$. The comparative statics with respect to any $\chi_i = \{c, c_D, L, \gamma\}$ are given by:

$$\frac{\partial \pi^{nc}(c)}{\partial \chi_i} = \frac{\partial \pi(1; \chi)}{\partial \chi_i} F(1) + \int_{1+}^{\bar{z}(\chi)} \frac{\partial \pi(z; \chi)}{\partial \chi_i} dF(z) .$$

Thus, the comparative statics are of the same sign as the corresponding comparative statics of the profit function for the core segment. ■

Open economy. Sales to the foreign market are subject to an ad-valorem cost $\tau \geq 1$ and a fixed cost $f_X \geq 0$. The expected value of the core segment from domestic and foreign sales when the market cutoff is c_D unconditional on making a successful entry are:

$$\begin{aligned} \tilde{\pi}_D &= \int_0^{c_D} \frac{L}{4\gamma} (c_D - c)^2 dG(c; \boldsymbol{\rho}) \\ \tilde{\pi}_X &= \int_0^{\frac{c_D - \sqrt{\frac{4\gamma f_X}{L}}}{\tau}} \left[\frac{L}{4\gamma} (c_D - \tau c)^2 - f_X \right] dG(c; \boldsymbol{\rho}) \end{aligned}$$

where $\boldsymbol{\rho}$ is the vector of parameters of the exogenous distribution of core competence costs $G(c)$. Taking the first order derivative yields:

$$\begin{aligned} \frac{\partial \tilde{\pi}_D}{\partial c_D} > 0 \quad \frac{\partial \tilde{\pi}_D}{\partial L} > 0 \quad \frac{\partial \tilde{\pi}_D}{\partial \gamma} < 0 , \\ \frac{\partial \tilde{\pi}_X}{\partial c_D} > 0 \quad \frac{\partial \tilde{\pi}_X}{\partial \tau} < 0 \quad \frac{\partial \tilde{\pi}_X}{\partial f_X} < 0 \quad \frac{\partial \tilde{\pi}_X}{\partial L} > 0 \quad \frac{\partial \tilde{\pi}_X}{\partial \gamma} < 0 . \end{aligned} \tag{30}$$

A segment with marginal cost zc earns a profit in the foreign market equal to $\pi(z\tau c) = \frac{L}{4\gamma} (c_D - z\tau c)^2$ and $\bar{z}_X(\tau c, c_D)$ is the maximum customization cost such that $\pi(\bar{z}_X(\tau c, c_D)\tau c) = f_X$. Domestic and export cutoff levels of customization costs are:

$$\begin{aligned}\bar{z}_D(c, c_D) &= \frac{c_D - \sqrt{\frac{4\gamma f_M}{L}}}{c}, \\ \bar{z}_X(\tau c, c_D) &= \frac{c_D - \sqrt{\frac{4\gamma f_X}{L}}}{\tau c}.\end{aligned}$$

To facilitate the analysis of comparative statics we change notation as before $\pi(z\tau; \chi) \equiv \pi(z\tau c)$ and $\bar{z}_X(\tau; \chi) \equiv \bar{z}_X(\tau c, c_D)$, where $\chi = \{c, c_D, L, \gamma\}$. The ex-ante expected value of non-core divisions in a firm with core competence cost c is given by:

$$\begin{aligned}\pi_D^{nc}(c) &= \pi(1; \chi)F(1) + \int_{1_+}^{\bar{z}_D(\chi)} \pi(z; \chi)dF(z) - F(\bar{z}_D(\chi))f_M \\ \pi_X^{nc}(c) &= \pi(\tau; \chi)F(1) + \int_{1_+}^{\bar{z}_X(\chi)} \pi(z\tau; \chi)dF(z) - F(\bar{z}_X(\chi))f_X.\end{aligned}$$

The signs of comparative statics on $\pi_D^{nc}(c)$ and $\pi_X^{nc}(c)$ are the same as $\pi_D(c)$ and $\pi_X(c)$. Taking the expectation over the core competence cost yields the unconditional expected value of non-core divisions

$$\begin{aligned}\tilde{\pi}_D^{nc} &= \int_0^{c_D} \pi_D^{nc}(c)dG(c; \boldsymbol{\rho}) \\ \tilde{\pi}_X^{nc} &= \int_0^{\frac{c_D - \sqrt{\frac{4\gamma f_X}{L}}}{\tau}} \pi_X^{nc}(c)dG(c; \boldsymbol{\rho})\end{aligned}$$

which are characterized by the same comparative statics as (30):

$$\begin{aligned}\frac{\partial \tilde{\pi}_D^{nc}}{\partial c_D} > 0 & \quad \frac{\partial \tilde{\pi}_D^{nc}}{\partial L} > 0 & \quad \frac{\partial \tilde{\pi}_D^{nc}}{\partial \gamma} < 0, \\ \frac{\partial \tilde{\pi}_X^{nc}}{\partial c_D} > 0 & \quad \frac{\partial \tilde{\pi}_X^{nc}}{\partial \tau} < 0 & \quad \frac{\partial \tilde{\pi}_X^{nc}}{\partial f_X} < 0 & \quad \frac{\partial \tilde{\pi}_X^{nc}}{\partial L} > 0 & \quad \frac{\partial \tilde{\pi}_X^{nc}}{\partial \gamma} < 0.\end{aligned}\tag{31}$$

We are now in the position to determine the comparative statics on the expected value of a firm before entry, which lead to the proof of Proposition 2.

The expected value of a firm unconditional on making a successful entry is the sum of the two components, from domestic sales and sales in the foreign market:

$$\Pi_D(c_D; L, \gamma, \boldsymbol{\rho}) = \tilde{\pi}_D + \tilde{\pi}_D^{nc} \quad \Pi_X(c_D; \tau, f_X, L, \gamma, \boldsymbol{\rho}) = \tilde{\pi}_X + \tilde{\pi}_X^{nc},$$

where we made the parameters explicit. The total expected value of a firm unconditional

on making a successful entry is

$$\Pi(c_D; \tau, f_X, L, \gamma, \boldsymbol{\rho}) = \Pi_D(c_D; L, \gamma, \boldsymbol{\rho}) + \Pi_X(c_D; \tau, f_X, L, \gamma, \boldsymbol{\rho}) ,$$

whose comparative statics are implied by (30) and (31):

$$\frac{\partial \Pi}{\partial c_D} > 0 \quad \frac{\partial \Pi}{\partial \tau} < 0 \quad \frac{\partial \Pi}{\partial f_X} < 0 \quad \frac{\partial \Pi}{\partial L} > 0 \quad \frac{\partial \Pi}{\partial \gamma} < 0 . \quad (32)$$

Finally, changes in the parameters of the distribution $G(c)$ do not effect the extremes of integration or the integrand functions involved in the determination of the expected value of the firm. Therefore, the comparative statics on the parameters $\boldsymbol{\rho}$ have the same sign as the corresponding comparative statics on the density:

$$\text{sign} \left\{ \frac{\partial \Pi}{\partial \rho_i} \right\} = \text{sign} \left\{ \frac{\partial^2 G(c; \boldsymbol{\rho})}{\partial^2 \rho_i} \right\} , \quad (33)$$

for every $\rho_i \in \boldsymbol{\rho}$. In the main body of the paper we refer to one parameter ρ , instead of a vector. However, the increase of any parameter $\rho_i \in \boldsymbol{\rho}$ which determines *ceteris paribus* a higher probability density implies a greater concentration in the distribution of core competence cost. Thus, the interpretation of the comparative statics with respect to concentration comes without loss of generality.

From (10) it is immediate to conclude that for $c_D = 0$ the value Π is null as well. Therefore, for every $f_E > 0$, there exists one and only one c_D^* such that $\Pi(c_D) < f_E$ for $c_D < c_D^*$ and $\Pi(c_D) > f_E$ for $c_D > c_D^*$. An analysis of the intersection $\Pi(c_D^*) = f_E$ given (32) determines the comparative statics on the market cutoff:

$$\begin{aligned} \frac{\partial c_D^*}{\partial \tau} > 0 \quad \frac{\partial c_D^*}{\partial f_X} > 0 \quad \frac{\partial c_D^*}{\partial L} < 0 \quad \frac{\partial c_D^*}{\partial \gamma} > 0 \\ \frac{\partial c_D^*}{\partial f_E} > 0 \quad \text{sign} \left\{ \frac{\partial c_D^*}{\partial \rho_i} \right\} = -\text{sign} \left\{ \frac{\partial^2 G(c; \boldsymbol{\rho})}{\partial^2 \rho_i} \right\} . \end{aligned} \quad (34)$$

8 Appendix B – further empirical evidence

Table 7 provides summary statistics for our main variables at the firm and segment level.

Table 7: **Descriptive statistics**

	mean	sd	min	max	count
<i>Panel (a): Firm</i>					
Q	1.65	0.69	0.59	6.87	3290
mean(marginal costs)	0.92	0.06	0.73	1.44	3290
sd(marginal costs)	0.04	0.05	0.00	0.56	3290
<i>Panel (b): Segment</i>					
multi-segment	0.83	0.38	0.00	1.00	16982
log(assets)	5.58	2.15	-5.90	13.26	16982
return on assets	0.12	0.37	-3.67	2.47	16982
marginal costs	-1.96	0.42	-4.22	-1.39	16982
Δ assets	0.56	0.98	-2.57	3.44	1909
Δ MC	0.00	0.34	-1.15	3.48	1909

Note: This table shows descriptive statistics for main variables. Sample size varies due to different levels of analysis.

Table 8 shows a hump-shaped relationship between segment assets and segment marginal costs, underlying Figure 3. Figure 4 shows that average marginal costs are higher among firms with more non-core segments. Table 9 controls for the average wage in each industry, based on the NBER manufacturing data base, and shows that the coefficients of interest remain unaffected.

Table 8: **Segment capital allocation and efficiency – regressions**

VARIABLES	(1) log(assets)	(2) log(assets)	(3) log(assets)	(4) asset share
marginal costs	8.863*** (2.119)	9.724*** (2.024)	10.475*** (2.865)	3.769*** (0.868)
marginal costs ²	-4.494*** (1.026)	-4.791*** (0.973)	-5.004*** (1.266)	-1.762*** (0.408)
Observations	11,525	11,525	11,495	11,594
R-squared	0.858	0.867	0.939	0.654
Firm FE	✓	✓	✓	-
Year FE	-	✓	-	-
Industry*Year FE	-	-	✓	✓

Note: This tables regresses the log of total segment assets on segment marginal costs and marginal costs squared. All regression cluster standard errors at the segment level and are weighted by segment sales. Column (4) uses segment assets as a share of total firm assets as dependent variable. *** p<0.01, ** p<0.05, * p<0.1.

9 Appendix C - online, not for publication

In this section of the appendix, we outline the derivations behind the results of the model that are discussed in the main body of the paper.

Consumer's problem

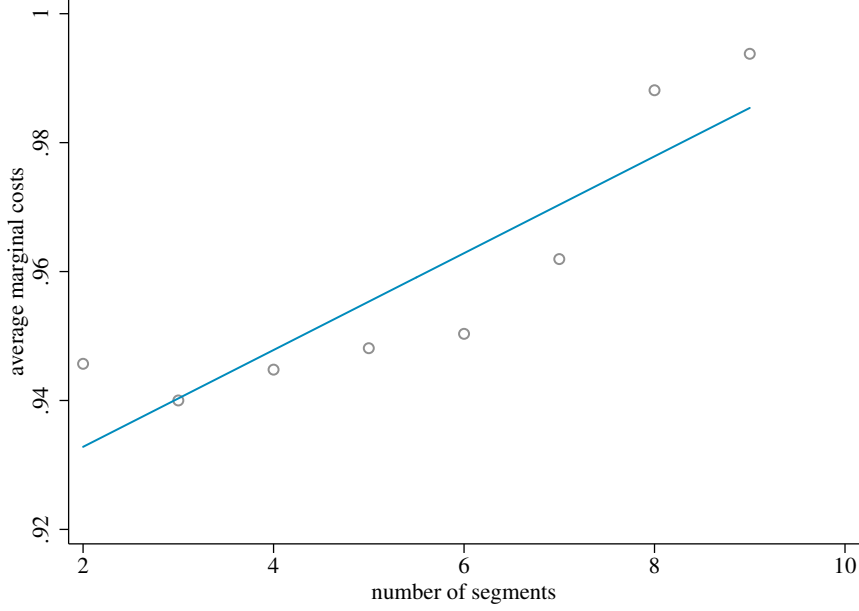
The consumer maximizes utility (1) subject to the budget constraint

$$\begin{aligned}
 U &= q_o^c + \alpha \int_0^V q_v^c dv - \frac{\beta}{2} \left(\int_0^V q_v^c dv \right)^2 - \frac{\gamma}{2} \int_0^V (q_v^c)^2 dv, \\
 s.t. \quad &: p_o q_o^c + \int_0^V p_v q_v^c dv \leq I^c
 \end{aligned}$$

where I^c is consumer's income. A strictly positive consumption of the outside good implies a constant marginal utility of income, that is equal to $1/p_o$. The outside good is the numeraire, therefore $p_o \equiv 1$.

Substituting in the first order condition for the consumption of differentiated good yields the inverse demand $p_v = \alpha - \gamma q_v^c - \beta Q^c$, thus, the linear uncompensated demand

Figure 4: Segment capital allocation and efficiency



Note: This figure provides a firm-level binned scatterplot of average marginal costs on the y-axis against the number of segments on the x-axis. Average marginal costs are higher among firms with more non-core segments.

function

$$q_v^c = \frac{1}{\gamma} (\alpha - p_v - \beta Q^c) .$$

Integrating over the set of varieties V yields the household consumption of differentiated good $Q^c = (\alpha - \bar{p}) \frac{V}{\gamma + \beta V}$, where $\bar{p} = \frac{1}{V} \int_0^V p_v dv$ is the average price across consumed varieties. Substituting back in the demand for a certain variety yields:

$$q_v^c = \frac{\alpha}{\gamma + \beta V} - \frac{1}{\gamma} p_v + \frac{\beta V}{\gamma + \beta V} \frac{1}{\gamma} \bar{p} .$$

By setting $q_v^c = 0$ yields the choke price that shuts down the demand of a certain variety, which is $p^{max} = \frac{1}{\gamma + \beta V} (\gamma \alpha + \beta V \bar{p})$. Thus, the demand for a certain variety can be written in terms of the choke price:

$$q_v^c = \frac{1}{\gamma} (p^{max} - p_v) .$$

Consumer's expenditure $\int_0^V p_v q_v^c dv$ is described my means of the choke price and by the first and second moments of the price distribution. The variance of prices is $\sigma_p^2 = \frac{1}{V} \int_0^V (p_v - \bar{p})^2 dv$, where $\bar{p} = \frac{1}{V} \int_0^V p_v dv$. Thus, the portion of consumer's income allo-

Table 9: Accounting for the average outside wage

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)
	Δ assets	nr boards Δ assets	time Δ assets	Δ mc	nr boards Δ mc	time Δ mc
efficient segment	-0.040 (0.032)	-0.069** (0.034)	-0.022 (0.032)	-0.017** (0.007)	-0.019*** (0.007)	-0.028*** (0.007)
Δ Chinese imports	-0.050 (0.055)	0.046 (0.074)	-0.034 (0.079)	0.051*** (0.011)	0.022 (0.015)	-0.014 (0.016)
efficient segment \times Δ Chinese imports	0.152** (0.075)	-0.179* (0.107)	-0.264** (0.104)	-0.063*** (0.015)	0.001 (0.022)	0.013 (0.021)
high friction		-0.054** (0.024)	-0.038** (0.018)		-0.001 (0.005)	-0.014*** (0.004)
efficient segment \times high friction		0.044** (0.021)	-0.155*** (0.023)		0.007 (0.004)	-0.019*** (0.005)
Δ Chinese imports \times high friction		-0.093 (0.141)	0.112 (0.104)		0.057** (0.029)	0.114*** (0.021)
efficient segment \times Δ Chinese imports \times high friction		0.734*** (0.150)	1.149*** (0.152)		-0.130*** (0.031)	-0.126*** (0.031)
average wage	-0.056 (0.066)	-0.066 (0.067)	-0.086 (0.066)	0.033** (0.013)	0.039*** (0.014)	0.017 (0.013)
efficient segment \times average wage	0.057 (0.062)	0.070 (0.061)	0.101 (0.064)	0.022* (0.013)	0.019 (0.013)	0.049*** (0.013)
Observations	1,876	1,876	1,876	1,876	1,876	1,876
Industry FE	✓	✓	✓	✓	✓	✓
Year FE	✓	✓	✓	✓	✓	✓

Note: The dependent variable is the change in segment log assets ($\Delta assets$) or marginal costs (Δmc). *efficient segment* is a dummy with value one for the most-efficient segments within a firm in terms of average return on assets. Δ *Chinese imports* denotes the change in Chinese import penetration at the industry level from 1999 to 2007, instrumented with Chinese imports in 8 other advanced economies. *low (high) friction* refer to firms below (above) the median in terms of number of boards the average CEO sits on, or below (above) the median in terms of the years the average CEO sits on the board. All regression are weighted by segment sales. *** p<0.01, ** p<0.05, * p<0.1

cated to differentiated goods is $I^d = \bar{p}Q^c - \frac{V}{\gamma}\sigma_p^2$. Consumer's expenditure on the outside good is the residual $I_o^c = I^c - I_d^c > 0$.

Outside sector

The outside sector is competitive, thus the price p_o is equal to the marginal cost of production. The technology for producing an outside good employs labor and capital as perfect substitutes:

$$y_o = l + \theta k .$$

The implied cost function is $\min\{wy_o, \frac{p_k}{\theta}y_o\}$, where w is the price of one unit of labor and p_k is the rental price of one unit of capital. Both labor and capital are employed in the production of the outside good if and only if $p_k \equiv \theta w$. Under these circumstances, the marginal cost of one unit of outside good is equal to w . By perfect competition $w = p_o$, thus, the price of one unit of labor is equal to the price of the numeraire good $w = 1$ and

the rental price of capital is $p_k = \theta$.

Firm's problem

The firm minimizes the cost subject to the technology (3)

$$\begin{aligned} C &= wl + \theta k \\ \text{s.t.} \quad &: y = \frac{\varphi}{z_i c} l^\lambda k^{1-\lambda} . \end{aligned}$$

The equivalence between marginal rate of technical substitution $\frac{\lambda}{1-\lambda} \frac{k}{l}$ and relative price is $\frac{w}{\theta}$ yields the derived optimal factor demand:

$$\begin{aligned} l &= \frac{z_i c}{\varphi} \left(\frac{\theta}{w} \frac{\lambda}{1-\lambda} \right)^{1-\lambda} y \\ k &= \frac{z_i c}{\varphi} \left(\frac{\theta}{w} \frac{\lambda}{1-\lambda} \right)^{-\lambda} y . \end{aligned}$$

The cost function is equal to:

$$C = \left[w \left(\frac{\theta}{w} \frac{\lambda}{1-\lambda} \right)^{1-\lambda} + \theta \left(\frac{\theta}{w} \frac{\lambda}{1-\lambda} \right)^{-\lambda} \right] \frac{z_i c}{\varphi} y$$

thus, the normalization $\varphi \equiv w \left(\frac{\theta}{w} \frac{\lambda}{1-\lambda} \right)^{1-\lambda} + \theta \left(\frac{\theta}{w} \frac{\lambda}{1-\lambda} \right)^{-\lambda}$ is convenient to have the marginal cost of a product i in a firm with core competence cost c equal to $z_i c$. The normalization $\varphi_l = \left(\frac{\theta}{w} \frac{\lambda}{1-\lambda} \right)^{\lambda-1} \varphi$ and $\varphi_k = \left(\frac{\theta}{w} \frac{\lambda}{1-\lambda} \right)^{\lambda} \varphi$ is convenient to write the factor demands simply as $l = \frac{z_i c}{\varphi_l} y$ and $k = \frac{z_i c}{\varphi_k} y$.

A firm producing a certain variety which sells at a price p faces an aggregate demand that is L times the individual demand, thus $q = \frac{L}{\gamma} (p^{max} - p)$. Using the inverse demand $p = p^{max} - \frac{\gamma}{L} q$ to obtain firm revenue yields a marginal revenue $p^{max} - \frac{2\gamma}{L} q$. The equivalence between marginal revenue and marginal cost implies the profit maximizing quantity, which, substituted in the inverse demand, yields the optimal price:

$$q = \frac{L}{2\gamma} (p^{max} - z_i c) \quad p = \frac{1}{2} (p^{max} + z_i c) .$$

A variety that is produced as a core competence does not require any customization cost $z_0 = 1$. The demand of such a variety is zero if and only if $c = p^{max}$. Therefore, the core competence marginal cost above which firms do not make sales in their domestic market is $c_D \equiv p^{max}$. Substituting in the expression of optimal quantity and price leads to the equilibrium firm level performances (4c).

Aggregate variables

Core marginal cost $c \sim G(c)$ and customization cost $z \sim F(z)$ are two independent random variables. Their product $\nu = zc$ is a random variable whose realizations correspond to the marginal cost varieties $\nu \in [0, V]$. Let $H(\nu)$ be the exogenous cumulative density function of marginal cost, unconditional on a successful entry. The probability density function of marginal cost is:

$$h(\nu) = \int_0^\infty \frac{g(c)f(\nu/c)}{c} dc ,$$

where $g(c)$ and $f(z)$ are the probability density function of c and z respectively. Varieties that are successfully produced are a fraction $H(c_D)$ of the measure of potential entrants M_E , which implies:

$$M_E = \frac{V}{H(c_D)} .$$

The average marginal cost across varieties that make a successful entry is $\bar{\nu} = H(c_D)^{-1} \int_0^{c_D} \nu dH(\nu)$. This allows the average price to be computed $\bar{p} = \frac{1}{2}(c_D + \bar{\nu})$. Substituting for $c_D \equiv p^{max}$ in the expression $p^{max} = \frac{1}{\gamma + \beta V} (\gamma\alpha + \beta V \bar{p})$ determines the measure of varieties:

$$V = \frac{\gamma \alpha - c_D}{\beta c_D - \bar{p}} .$$

The measure of incumbent firms M corresponds to the fraction of potential entrants with a core marginal cost $c \leq c_D$, that is:

$$M = G(c_D)M_E .$$

Firms with a core marginal cost $c \leq c_M(c_D)$ become a MSF, where the cutoff $c_M(c_D)$ is defined in (6). The average number of varieties per incumbent firm Ω and the average number of non-core segments per MSF are given by:

$$\Omega = \frac{V}{M} \quad \bar{m} = \frac{V - M}{G(c_M(c_D))M} .$$

There are L many consumers. In equilibrium, a measure $V - M$ consists of divisional managers and $L - (V - M)$ are workers. Some workers are employed in the differentiated sector to foster firm entry $L_E = f_E M_E$, others in production $L_P = \bar{\ell} V$, where $\bar{\ell} = H(c_D)^{-1} \int_0^{c_D} \ell(\nu) dH(\nu)$ and $\ell(\nu)$ is the optimal labor demand function in a segment with marginal cost ν . The residual measure of workers is employed in the outside sector $L_o = L - (V - M) - L_P - L_E$.

The economy is endowed with K units of capital. A measure of $K_P = \bar{\kappa} V$ units is employed in the differentiated sector, where $\bar{\kappa} = H(c_D)^{-1} \int_0^{c_D} \kappa(\nu) dH(\nu)$ and $\kappa(\nu)$ is the

optimal capital demand function in a segment with marginal cost ν . The residual units of capital are employed in the outside sector $K_o = K - K_P$.

Let $\bar{r} = H(c_D)^{-1} \int_0^{c_D} \tilde{r}(\nu) dH(\nu)$ and $\bar{\pi} = H(c_D)^{-1} \int_0^{c_D} \tilde{\pi}(\nu) dH(\nu)$ be the revenue and profit functions in a segment with marginal cost ν . Thus, aggregate revenue and aggregate profit in the differentiated sector are equal to $\bar{r}V$ and $\bar{\pi}V$. Revenue of the outside sector is implied by the production function given the employment of labor and capital $Q_o = L_o + \theta K_o$.

The ownership of firms and factor of production is evenly distributed among consumers. Expenditure in consumption of differentiated good, consumption of outside good and financing firm entry is equal to the sum of labor income, capital income and profit:

$$\bar{r}V + Q_o + f_E M_E = L + \theta K + \bar{\pi}V .$$

All consumers earn a per capita income $I^c = (L + \theta K + \bar{\pi}V) / L$. Out of which, $I_d^c = \bar{r}V / L$ is the expenditure in differentiated goods, $I_o^c = Q_o / L$ is the expenditure in the outside good, and the residual $\bar{\pi}V / L$ is allocated to financing the entry of new firms. Individual welfare corresponds to the indirect utility function associated with the consumer's problem.

Welfare

Substituting $q_o^c = Q_o / L = I_o$, for the individual demand $q^c(\nu) = \frac{1}{2\gamma}(p^{max} - \nu)$, for $p^{max} = c_D$ and $Q_c = \int_0^V q^c(\nu) = (\alpha - \bar{p}) \frac{V}{\gamma + \beta V}$ in (1) yields individual welfare:

$$W = I_o + \alpha \frac{(\alpha - \bar{p})V}{\gamma + \beta V} - \frac{1}{2} \frac{V}{\gamma} [(c_D - \bar{p})^2 + \sigma_p^2] - \frac{\beta}{2} (\alpha - \bar{p})^2 \left(\frac{V}{\gamma + \beta V} \right)^2$$

where $\int_0^V [c_D - p(v)] dv = V(c_D - \bar{p})$ and $\int_0^V [c_D - p(v)]^2 dv = V(c_D^2 - 2c_D\bar{p} + \bar{p})$ and $\sigma_p^2 = \bar{p} - \bar{p}^2$ with $\bar{p} = H(c_D)^{-1} \int_0^{c_D} p(\nu)^2 dH(\nu)$. Substituting for $\nu \equiv z_i c = 2p(\nu) - c_D$ in the expression of the revenue and dividing by the mass of agents L allows the average individual expenditure in a given variety to be determined. Thus, the individual expenditure in differentiated goods is $I_d^c = \frac{V}{\gamma} [(c_D - \bar{p})\bar{p} - \sigma_p^2]$. Expenditure in the outside good is $I_o = I^c - I_d^c$. Substituting in the expression of welfare yields:

$$W = I^c + \left(\frac{1}{2} \frac{V(\alpha - \bar{p})^2}{\gamma + \beta V} \right) + \frac{\sigma_p^2}{2} \frac{V}{\gamma}$$

where $c_D - \bar{p} \equiv \frac{\gamma}{\gamma + \beta V} (\alpha - \bar{p})$, given the expression for $p^{max} = \frac{1}{\gamma + \beta V} (\gamma\alpha + \beta V\bar{p})$.

Firm performances in open economy

Let $\mathbf{1}_{[z_i c]}$ be an indicator function that is $\mathbf{1}_{[z_i c]} = 1$ if there are exports in segment i of a firm c and zero otherwise. Firm performances at the segment level in open economy are:

$$\begin{aligned} q(z_i c) &= \frac{L}{2\gamma} [(c_D - z_i c) + \mathbf{1}_{[z_i c]} (c_D - z_i \tau c)] \\ r(z_i c) &= \frac{L}{4\gamma} [(c_D^2 - (z_i c)^2) + \mathbf{1}_{[z_i c]} (c_D^2 - (z_i \tau c)^2)] \\ l(z_i c) &= \frac{z_i c}{\varphi_l} \frac{L}{2\gamma} [(c_D - z_i c) + \mathbf{1}_{[z_i c]} (c_D - z_i \tau c)] \\ k(z_i c) &= \frac{z_i c}{\varphi_k} \frac{L}{2\gamma} [(c_D - z_i c) + \mathbf{1}_{[z_i c]} (c_D - z_i \tau c)] \\ \pi(z_i c) &= \frac{L}{4\gamma} [(c_D - z_i c)^2 + \mathbf{1}_{[z_i c]} (c_D - z_i \tau c)^2] . \end{aligned}$$

Endogenous sources of heterogeneity

In this section, we show how the introduction of an internal capital market allows us to endogenise the cost structure of multi-segment firms, which remains exogenous in the multi-product-firms literature.

Managers strategically over-report the cost of their divisions depending on the true customization cost of the division x_i ; the core marginal cost of the firm c ; the number of non-core divisions m ; and competition in the output market, through c_D (Proposition 1). Consequently, the cost structure of a firm becomes a distinct feature of the firm's organisation: the firm's organisation acts as a glue. The cost of a segment depends not only on its customization costs but also on the competition for funds in the internal capital market and the number of segments a firm operates.

To illustrate this point, we compare the relative cost across divisions in Mayer et al. (2014) with our setup. In their model, the relative marginal cost between two products of the same firm, say i and j , is exogenously determined by the ratio of their customization costs. In our model, the relative marginal cost between two products becomes endogenous to the four determinants of misreporting

$$\frac{z_i c}{z_j c} = \frac{\mu^*(x_i, c, m, c_D) x_i}{\mu^*(x_j, c, m, c_D) x_j} \neq \frac{x_i}{x_j} ,$$

where the strategic over-reporting by the two managers generates a distortion to the allocation of capital. Because the allocation of capital is increasing in the reported marginal cost, both non-core divisions are characterised by an excess of capital $k(z_i, c) > k(x_i, c)$ and $k(z_j, c) > k(x_j, c)$.

This property extends to a comparison across firms. The marginal costs of two products with the same customization cost but produced in different firms, say with core marginal costs c' and c'' , and/or with m' and m'' non-core divisions:

$$\frac{z_i c'}{z_i c''} = \frac{\mu^*(x_i, c', m, c_D)}{\mu^*(x_i, c'', m, c_D)} \frac{c'}{c''} \neq \frac{c'}{c''} \quad \text{or} \quad \frac{z_i c'}{z_i c''} = \frac{\mu^*(x_i, c', m', c_D)}{\mu^*(x_i, c'', m'', c_D)} \frac{c'}{c''} \neq \frac{c'}{c''},$$

are no longer exogenous as in Mayer et al. (2014). Our model predicts that more capital is allocated to the division of the better firm (lower c) and, given the same core competence cost, to the division of the firm with a wider number of non-core segments (greater m).

Moreover, the result that changes in competition (such as a lower output market cutoff c_D) propagates through the cost structure of multi-segment firms and is a distinctive feature of our approach, due to the strategic behavior of managers as captured by the endogenous factor of misreporting $\mu^*(x_i, c, m, c_D)$. Through this channel the policies that affect the output market have an heterogeneous impact on products and firms.