

## WHAT DETERMINES THE SCOPE OF THE FIRM OVER TIME? A FOCUS ON INSTITUTIONAL RELATEDNESS

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“What determines the scope of the firm?” is one of the most fundamental questions in strategic management. We argue that, in addition to product relatedness, a focus on institutional relatedness—defined as an organization’s informal linkages with dominant institutions that confer resources and legitimacy—helps answer this question. We address this question both longitudinally (firms in developed and emerging economies over time) and cross-sectionally (developed versus emerging economies), thus contributing to an institution-based theory of corporate diversification.

As part of the broader intellectual movement centered on new institutionalism throughout the social sciences in recent decades (North, 1990; Powell & DiMaggio, 1991; Scott, 1995; Williamson, 2000), strategic approaches to organization are considering institutional forces much more explicitly than before (Henisz, 2003; Oliver, 1997; Peng, 2003, 2006). Researchers increasingly realize that institutions are more than background conditions and that “institutions *directly* determine what arrows a firm has in its quiver as it struggles to formulate and implement strategy” (Ingram & Silverman, 2002: 20; emphasis added). Positioned to deepen our understanding of how an institutional perspective adds to strategy re-

search, this article addresses the question “What determines the scope of the firm?”—one of the four most fundamental questions in strategic management identified by Rumelt, Schendel, and Teece (1994: 564).

Although scholars in the strategy field have pursued the scope of the firm question for three decades, clear answers have remained elusive. Drawing on three streams of research, we argue that scope is driven by a combination of product and institutional relatedness. The first stream highlights the importance of organizational integration and disintegration over time (Lawrence & Lorsch, 1967). Although findings since Rumelt (1974) generally suggest that, in developed economies, unrelated product diversification (conglomeration) tends to destroy value, conglomeration has been found to *add* value during an earlier era (Davis, Diekmann, & Tinsley, 1994). Given that conclusions reached in different studies may be influenced by their sample period (Mayer & Whittington, 2003), a more meaningful question seems to be “What determines the scope of the firm over *time*?” (Lee, Peng, & Lee, 2003). The second stream of research posits that conglomeration may help firms overcome institutional imperfections prevalent in emerging countries (Chang & Hong, 2000; Guillen, 2000; Khanna & Palepu, 1997). The third stream focuses on the changes in the rules

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of the game as economies develop (Hoskisson, Eden, Lau, & Wright, 2000; North, 1990), putting a great deal of emphasis not only on markets but also on institutional transitions that influence corporate scope. It is argued that, during an early phase of transitions, a relationship-based strategy would be preferred (Peng & Heath, 1996), whereas a market-centered strategy would surface during a late phase of transitions characterized by more formal market-supporting institutions (Peng, 2003).

Extending earlier work of Peng (2003)<sup>1</sup> that focuses on how institutional transitions affect strategic choices in general, we probe how institutional transitions affect a specific and important form of corporate strategy: diversification. We maintain that a firm's product scope depends not only on its product relatedness but also its institutional relatedness, which refers to the degree of informal embeddedness with the dominant institutions in the environment that confer resources and legitimacy on the focal organization. Since most existing work has dealt with product relatedness, in the remainder of this article we develop our argument focusing on institutional relatedness and its impact on the scope of the firm over time.

### DIVERSIFICATION RESEARCH IN DEVELOPED AND EMERGING ECONOMIES

Scope refers to the number of different economic activities (industries, segments, product lines) a firm is engaged in (Jones & Hill, 1988). In developed economies, the value of product scope seems to change over time. Up until the 1970s, a broad scope based on a large number of unrelated product markets was deemed valuable (Palich, Cardinal, & Miller, 2000). However, the consensus since Rumelt (1974) seems to favor related diversification and to discredit unrelated diversification (Palich et al., 2000). This change has been documented by the dramatic reversal in investor sentiment toward conglomeration—"positive in the 1960s, neutral in the 1970s, and negative in the 1980s" (Matsusaka, 1993: 358). Relative to a more recent era (since the 1980s), external capital markets before the

1970s were less developed. Thus, conglomerates were perceived *ex ante* by external capital markets to have an advantage in allocating capital. Over time, as external capital markets developed, this conglomerate advantage likely became less important (Liebeskind, 2000).

The value of product scope seems to be different in emerging economies, which are "low-income, rapid-growth countries using economic liberalization as their primary engine of growth" (Hoskisson et al., 2000: 249). The striking institutional differences between emerging and developed economies have brought new institutionalism to the center stage of strategy research on emerging economies (Peng, 2000, 2003; Wright, Filatotchev, Hoskisson, & Peng, 2005). Although Western media and advisors often suggest that conglomerates destroy value and should be dismantled, recent evidence suggests otherwise. For instance, in Argentina, India, Indonesia, Israel, Peru, South Africa, South Korea, and Taiwan, Chang and Hong (2000), Guillen (2000), Khanna and Palepu (1999, 2000), Khanna and Rivkin (2001), and Lee et al. (2003) report that some (but not all) units affiliated with conglomerates enjoy higher profitability than independent firms. Therefore, it seems plausible to ask whether the relatively positive link between conglomeration and performance in emerging economies is a function of the level of institutional (under)development, a perspective we develop next.

### INSTITUTIONAL RELATEDNESS

Although relatedness traditionally has been measured by product market characteristics (Rumelt, 1974), recent research suggests that market-based activities are significantly influenced by *nonmarket* institutional factors (Ingram & Silverman, 2002; Oliver, 1997; Peng, 2003, 2006). Extending this idea to diversification research, a more encompassing notion, termed *institutional relatedness*, seems to make sense.<sup>2</sup> Specifically, we define institutional relatedness as the degree of *informal* embeddedness or interconnectedness with dominant institutions. Such embeddedness confers resources and in-

<sup>1</sup> In an early working paper, Shuhe Li (1999) discussed a series of issues related to rule- and relationship-based frameworks, which may be of interest to readers.

<sup>2</sup> To the best of our knowledge, Ilinitch and Zeithaml (1995) first proposed the term *institutional relatedness*. However, it refers to product-based "institutional" relatedness and does not draw on the new institutionalism literature.

creases the legitimacy of an organization (Granovetter, 1985; Oliver, 1997; Powell & DiMaggio, 1991). A high degree of institutional relatedness means that there is a dense network of ties with dominant institutions.

Institutional relatedness helps firms capitalize on economies of scope based on three non-market forms of capital: social capital, political capital, and reputational capital. First, social capital is defined by Adler and Kwon as "the goodwill available to individuals or groups" (2002: 23). Especially in emerging economies, the uncertain environment results in a great deal of information asymmetry, leading to a potentially high level of opportunism when dealing with unknown parties. Therefore, social capital embedded in networks may become more important (Peng & Heath, 1996). This may be one of the reasons why closely networked conglomerates exist and perform better in emerging economies (Khanna & Palepu, 1997). However, as formal institutions develop, external monitoring mechanisms improve, and such nonmarket social relationships gradually may become less important (Peng, 2003, 2006).

Second, political capital is geared toward increasing a firm's public reputation, social legitimacy, and political effectiveness when interacting with political actors. In emerging economies, political connections often affect profitability (Au, Peng, & Wang, 2000; Fisman, 2001; Peng & Luo, 2000). Since it is uncertain when and where opportunities from political connections would come from, it may be better for firms to cultivate *continuous* relationships with governments. However, formal institutional development, such as the creation of specialized government agencies to deal with specific industries or domains (e.g., the U.S. International Trade Commission), would require firms to come up with industry-specific political strategies (Lenway & Rehbein, 1991), which may be better tailored to the business level (as opposed to the corporate level). As a result, corporate-wide economies of scale in political activities may be difficult to attain when specialized formal institutions develop (Shaffer & Hillman, 2000).

Third, reputational capital may reduce information asymmetry between firms and stakeholders such as consumers and employees (Shenkar & Yuchtman-Yaar, 1997). Because information search, especially in emerging economies, is costly, reputation can informally but

powerfully fill the information needs of stakeholders in multiple industries (Khanna & Palepu, 1997). However, as formal institutions develop, the reputation effect may be more limited to related products.

Social, political, and reputational capital are critical for emerging economies (Moore & Jennings, 1995; Peng, 2003).<sup>3</sup> Conglomerates in emerging economies typically develop and excel in their capability for repeated industry entries, consisting of a bundle of skills to obtain licenses from the state, arrange financing, secure technology, and hire and train labor forces. This generic, nonindustry-specific capability involves more than ties to government officials; it embodies an ability to leverage relationships with a variety of crucial institutions (e.g., financial institutions, labor forces). Moreover, this capability is difficult to trade, because it is embodied in an organization's knowledge, contacts, and routines. Therefore, such a capability "encourages those who possess it to diversify across industries rather than become specialists in one industry or product line" (Guillen, 2000: 365).

### PRODUCT RELATEDNESS + INSTITUTIONAL RELATEDNESS

How do product and institutional relatedness combine to determine scope? Overall, it is important to recognize that firms have limited resources and that resources are required to develop any kind of relatedness—product, institutional, or both. A value-adding strategy is to leverage appropriate resources to develop the kind of relatedness that is most conducive in creating value in a given institutional framework. Both product and institutional relatedness become valuable over time as firms expand in scope, but then the value of this combined form may change.

Take Figure 1, depicting a snapshot of a particular period (i.e., the 1990s), as an example. Firms in Cells 1 and 2 can be found mostly in developed economies where formal institutions are well developed. The difference between

<sup>3</sup> We are not arguing that institutional relatedness is not important in developed economies. For example, Oliver (1997) and Ingram and Silverman (2002) argue that institutional relatedness is highly relevant for developed economies.

**FIGURE 1**  
**The Importance of Product and Institutional Relatedness: A Snapshot of the 1990s**

		<i>Institutional relatedness</i>	
		Low	High
<i>Product relatedness</i>	Low	<u>Cell 1:</u> Product-unrelated and institutionally unrelated diversification (Example: GE)	<u>Cell 3:</u> Product-unrelated and institutionally related diversification (Example: Tata)
	High	<u>Cell 2:</u> Product-related and institutionally unrelated diversification (Example: P&G)	<u>Cell 4:</u> Product-related and institutionally related diversification (Example: Honda)

Cells 1 and 2 boils down to whether firms pursue the efficient operation of an internal capital market or the sharing of core competencies, respectively. Firms in Cells 3 and 4 exploit institutional relatedness. Firms in Cell 3 are most likely to be found in emerging economies, where institutional relatedness is important enough to generate most profits and value added through product relatedness may be relatively small. Firms in Cell 4 are most likely to be found in an economy where formal institutions are relatively well developed but informal institutions are still influential (e.g., Japan).

Firms in Cell 3, which would be empirically classified as "unrelated" by traditional methods, may actually enjoy a great deal of institutional relatedness. Since institutional relatedness is often less visible than product relatedness, firms' capability in leveraging institutional relatedness thus becomes a more difficult-to-imitate resource (Barney, 1991), hence necessitating strategic consideration of its importance.

#### **ECONOMIC BENEFITS, BUREAUCRATIC COSTS, AND INSTITUTIONAL RELATEDNESS**

The existing literature suggests that diversification strategy is essentially a function of economic benefits and bureaucratic costs. Overall, it is "the difference between *relative* benefits

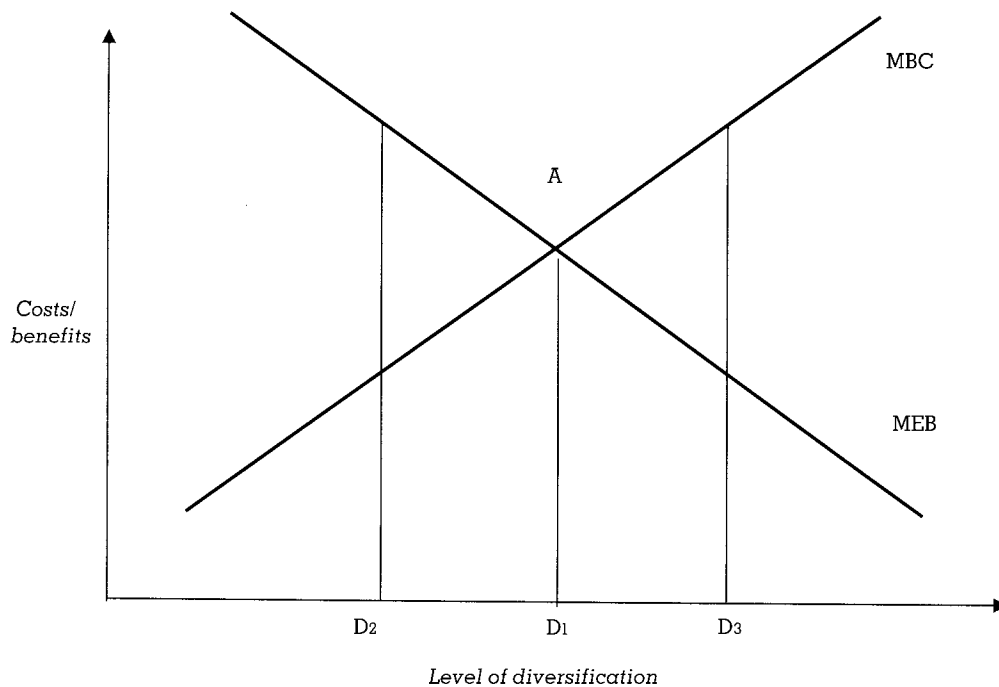
and costs that leads to the choice between strategies" (Jones & Hill, 1988: 160). Since the economic benefits of the last unit of growth (e.g., the last acquisition) can be defined as marginal economic benefits (MEB) and the additional bureaucratic costs incurred as marginal bureaucratic costs (MBC), the scope of the firm is determined by a comparison of MEB and MBC. Graphically (Figure 2), according to Collis and Montgomery (1997) and Jones and Hill (1988), the optimal scope is at point A, where the level of diversification is  $D_1$ . If the level of diversification is  $D_2$ , there are some economic benefits to gain by moving up to  $D_1$ . Conversely, if a firm overdiversifies to  $D_3$ , downscoping to  $D_1$  becomes necessary.

While this framework is insightful, an institutional perspective adds that MEB and MBC are, at least in part, determined by institutional relatedness (Kogut, Walker, & Anand, 2002; Wan & Hoskisson, 2003). Consequently, we undertake a series of analyses next.

#### **A Longitudinal Analysis in Developed Economies**

Taking the United States as an example, between the 1950s and 1970s the federal government, through a set of *formal* constraints, probably inadvertently promoted conglomeration. The post-1950 antitrust policies eliminated hori-

**FIGURE 2**  
**What Determines the Scope of the Firm?**



Adapted from Jones and Hill (1988: 166) and Collis and Montgomery (1997: 115). MEB: marginal economic benefits; MBC: marginal bureaucratic cost.

zontal and vertical expansion—viewed as potentially anticompetitive—as viable growth strategies. Thus, firms seeking growth were forced to look beyond their primary industry. Graphically, in Figure 3, if we hold MBC constant (an assumption relaxed later), the MEB curve shifted upward between 1950 and 1970. Consequently, the optimal scope expanded from  $D_1$  to  $D_2$ .

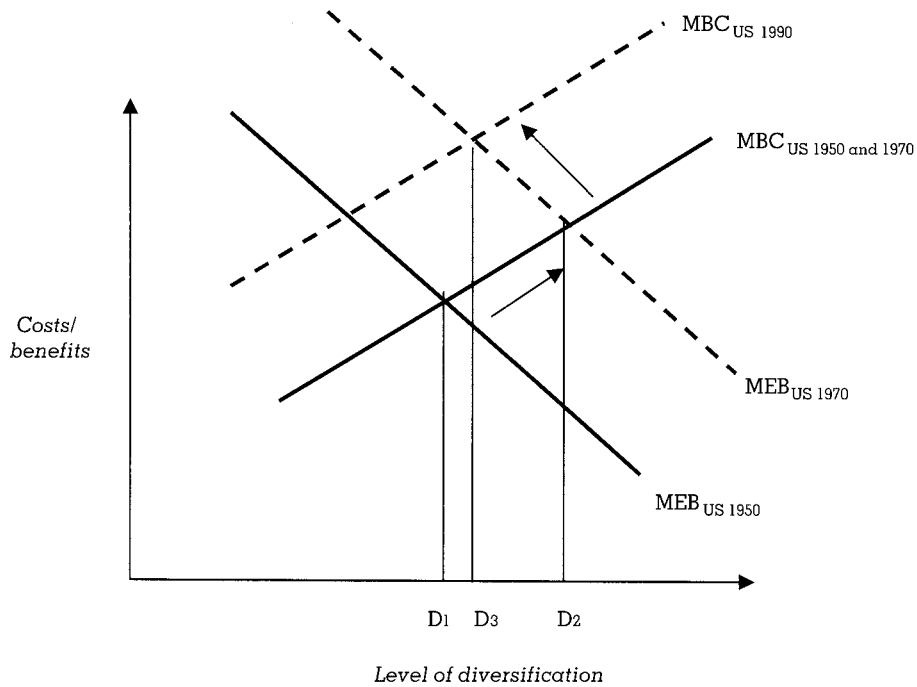
However, by the early 1980s, the *formal* constraints in favor of conglomeration changed substantially. Horizontal mergers were no longer critically scrutinized by the Reagan administration. Academic research since Rumelt (1974) increasingly pointed out the rising MBC. Innovations in takeover financing (e.g., junk bonds) made more conglomerates potential acquisition targets. Financial markets consequently reacted negatively to conglomerates. In other words, the previous legitimacy-enhancing *informal* norms in favor of conglomeration diminished (Davis et al., 1994). In some fashion, all these factors shifted downward, moving  $D_2$  back to a point near  $D_1$  (e.g.,  $D_3$ ) by approximately 1990 (Figure 3).

### A Cross-Sectional Analysis Between Emerging and Developed Economies

Figure 4 shows, cross-sectionally, how conglomerates in emerging economies may add value at a higher level of diversification, whereas firms in developed economies are not able to. This analysis relies on two critical assumptions (to be relaxed later). The first is that  $MEB_E > MEB_D$ . Underdeveloped *formal* institutional frameworks in emerging economies suggest this assumption. Politically, instability plagues many emerging economies (Henisz, 2003). As a result, corporate political linkages, which are beneficial for firms in developed economies, may be *more* important in emerging economies (Peng & Luo, 2000). These conditions potentially lead to some conglomeration advantage (Khanna & Palepu, 1997).

The second assumption is that, at a given level of diversification,  $MBC_E < MBC_D$ . This primarily draws on the *informal* aspects of the institutional frameworks. In emerging economies, because of the weaknesses of formal institutions, "informal constraints rise to play a *larger*

**FIGURE 3**  
**The Evolution of the Scope of the Firm in the United States: 1950–1970 and 1970–1990**



role in regulating economic exchanges” (Peng & Heath, 1996: 504; emphasis added). Although managers all over the world cultivate considerable interpersonal ties, managers in emerging economies perhaps “rely more heavily on the cultivation of personal relationships to cope with the exigencies of their situation” (Child, 1994: 150).

Overall, for any scope between  $D_1$  and  $D_2$  (e.g.,  $D_3$ ) in Figure 4, firms in developed economies at point C need to be downscoped toward point A ( $D_1$ ), whereas there is still room for firms to gain in emerging economies at point D, which can move up to point B ( $D_2$ ).

**A Longitudinal Analysis in Emerging Economies**

Figure 5 shows longitudinally how firms in emerging economies may derive or lose net benefits at a high level of diversification over time. First, in Figure 5a we shift  $MBC_{E1}$  up to  $MBC_{E2}$  (for simplicity,  $MEB_{E1}$  remains the same; it will change in Figure 5b). The increase in  $MBC$  may be because of (1) “overdiversification” beyond the optimal point C due to agency motives and abuses, (2) the lack of cohesion among top executives

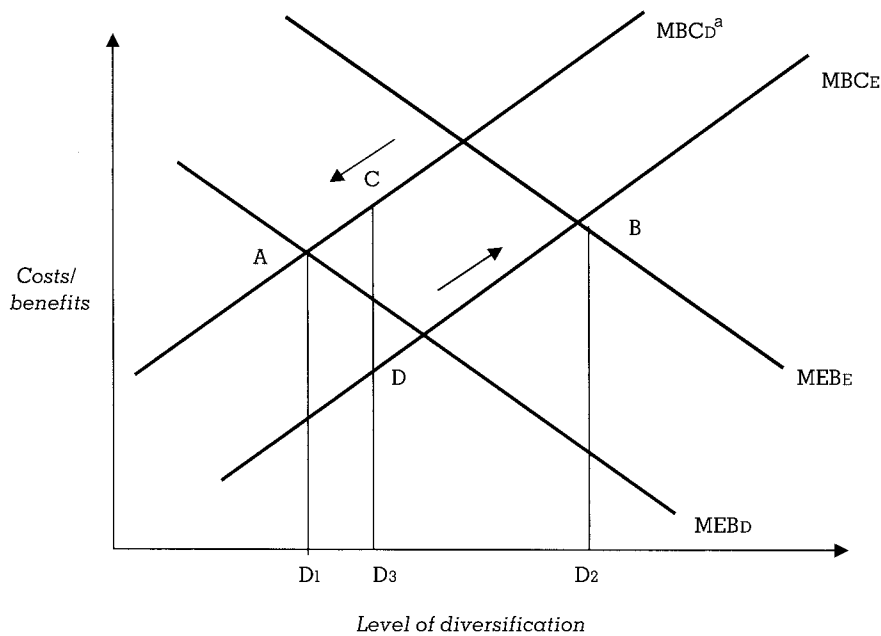
due to professional infights and family duels as organizational complexity grows, and/or (3) the arrival of Western or Western-trained managers. Therefore, firms need to downscope from point C ( $D_2$ ) to point B ( $D_3$ ), at an optimal level of diversification still higher than that for developed economies (i.e.,  $D_3 > D_1$ ). However, if we push the  $MBC_{E2}$  curve to  $MBC_{E3}$ , then the scope should be drastically cut back from point B ( $D_3$ ) to point D ( $D_4$ ).

Similarly, in Figure 5b, we can relax the other assumption by shifting  $MEB_{E1}$  toward  $MEB_{E2}$ . This may be due to improved formal institutions. Therefore, if  $MBC_{E1}$  remains the same, the optimal level of diversification is reduced from point C ( $D_2$ ) to point E ( $D_5$ ). If we use  $MBC_{E2}$  or  $MBC_{E3}$  discussed above, then the optimal level becomes point F ( $D_6$ ) or point G ( $D_7$ ), respectively. Note that at point F ( $D_6$ ), conglomerates in emerging economies can still add value, whereas at point G ( $D_7$ ) they cannot.

**PROPOSITIONS**

The analyses above suggest several propositions about the changing scope of the firm over time. Overall, it seems that “no organization can

**FIGURE 4**  
**The Optimal Scope of the Firm: Developed versus Emerging Economies at the Same Time**



<sup>a</sup>Subscripts D and E attached to MEB and MBC curves stand for *developed* and *emerging* economies, respectively. In developed economies the optimal point of diversification is still point A at  $D_1$ , as in Figure 2.

be properly understood apart from its wider social and cultural context" (Scott, 1995: 151). By extension, we believe that no answer to the scope of the firm question is complete without an appreciation of institutional relatedness. Above a certain threshold level (primarily for risk reduction purposes; see Palich et al., 2000), conglomeration cannot be argued to be either uniformly beneficial or uniformly costly without a specification of the institutional contingencies (Liebeskind, 2000). This argument, therefore, contrasts with the one-sided arguments solely derived from the recent Western experience, which discredit conglomeration. Our most fundamental proposition is as follows.

*Proposition 1: The higher the institutional relatedness (number and strength of informal ties with dominant institutions), the greater the scope of the firm.*

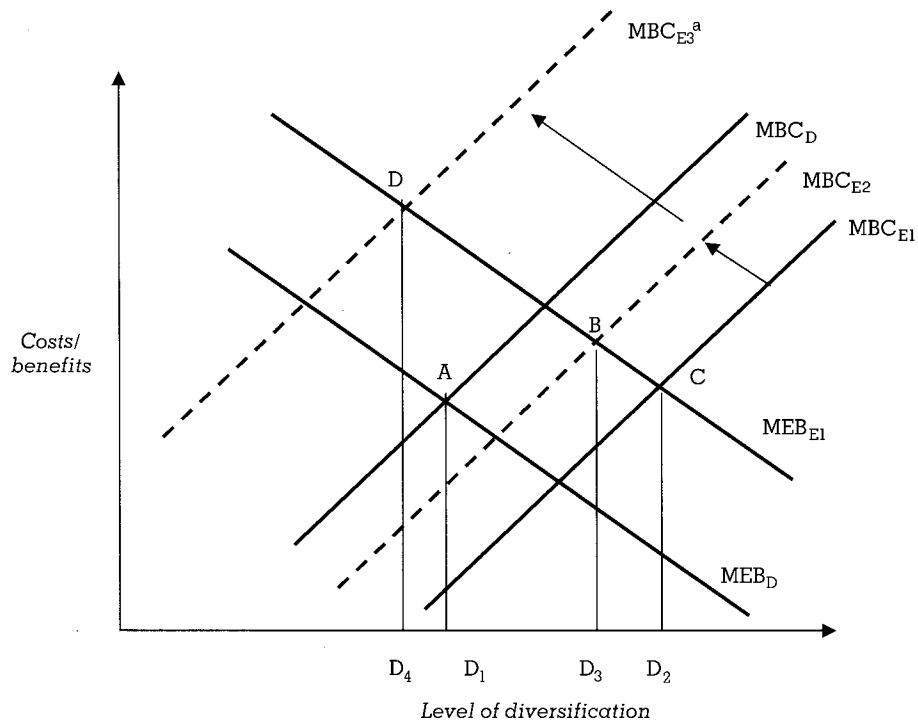
We consider two factors that have significant effects on institutional relatedness. One of the most significant formal institutional frameworks is formal financial institutions (North, 1990). One way to explain the changing senti-

ments in capital markets in developed economies lies in analyzing changes in institutional frameworks governing the relative costs and benefits of external versus internal capital markets. Capital market development may nullify the need for informal institutional ties to do business, because more efficient external capital markets may reduce the costs of formal contractual relationships between firms and external financiers. In other words, external capital markets and conglomeration (with internal capital markets) may be substitutes for each other (Liebeskind, 2000).

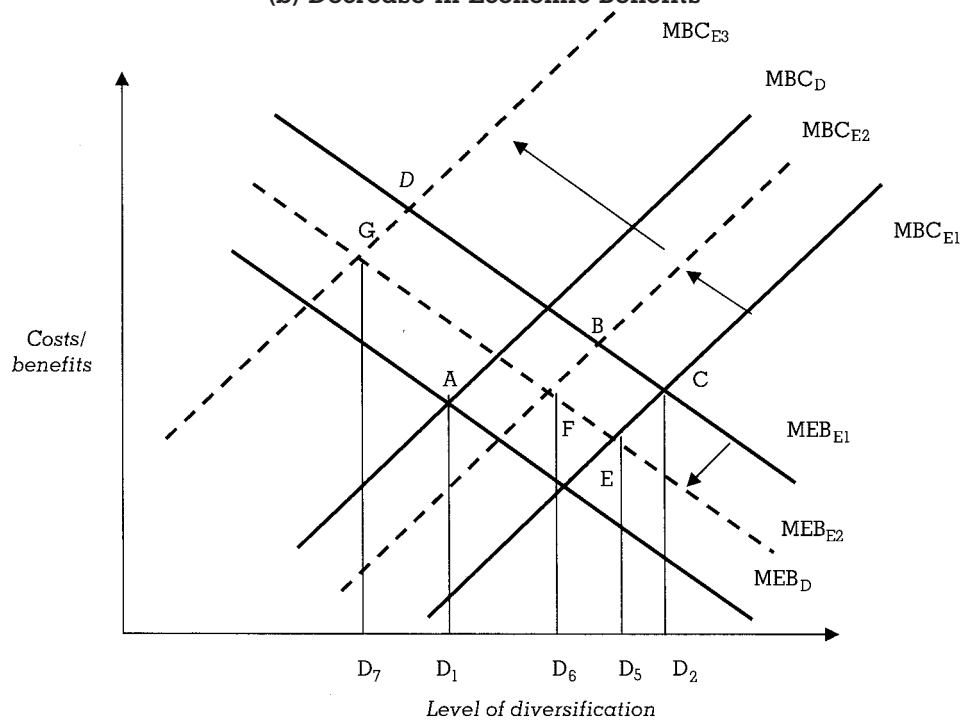
*Proposition 2: The higher the level of financial market development, the narrower the scope of the firm.*

Second, nonfinancial formal institutions, such as regulatory frameworks and competition policies, may also have a bearing on diversification strategies. According to the resource-based view, if conglomerates' advantage is to be sustained, it is imperative that certain limits to competition (e.g., government-imposed entry barriers) exist (Guillen, 2000). Once governments start the process of privatization, liberalization,

**FIGURE 5**  
**The Evolution of the Scope of the Firm in Emerging Economies**  
**(a) Increase in Bureaucratic Costs**



**(b) Decrease in Economic Benefits**



<sup>a</sup>Subscripts D and E attached to MEB and MBC curves stand for *developed* and *emerging* economies, respectively. In developed economies the optimal point of diversification is still point A at  $D_1$ , as in Figure 2.

and globalization, the relative importance of institutional relatedness may decline, whereas the relative importance of product relatedness rises. Such evolution in developed and emerging economies has been documented by Guillen (2000) and Toulan (2002), drawing on samples of conglomerates in Spain and Argentina, respectively.

*Proposition 3: The better developed the formal market-supporting institutions, the narrower the scope of the firm.*

Institutions are not static, nor are strategies. How, then, do they evolve over time, especially in emerging economies? In emerging economies formal, market-supporting institutions may eventually pick up some of the functions currently performed by conglomerates, thus reducing the value of institutional relatedness (Lee et al., 2003). The development of market-supporting institutions is also likely to facilitate the widening of alliance relationships, because unfamiliar parties, who would have been deterred from entering into relationships before, are now confident enough to collaborate in order to capture the gains from more complex exchanges (Peng, 2003). Alliances with other firms may gradually become a less costly way of doing business, compared to internalizing many transactions as before.

*Proposition 4: In the long run, the importance of institutional relatedness is likely to decline, and the optimal scope of the firm is likely to contract.*

However, "How long is the long run?" remains debatable. Because chaos and setback may prevail, in the short run, Proposition 4 may not hold. Although the general direction throughout emerging economies is to introduce more formal market-supporting institutions, their development is almost certain to be uneven (Peng, 2003). Certain sectors are likely to be deregulated while others remain state controlled. In these half-reformed economies, conglomerates, by leveraging their institutional relatedness, may emerge as intermediaries that connect the opened and closed sectors (Guillen, 2000). During the transitions, at least in the short run, such intermediation capabilities "are likely to become more, not less, valuable for exploiting new

business opportunities in the economy" (Khanna & Palepu, 1999: 279; emphasis added).

*Proposition 5: In the short run, the importance of institutional relatedness is likely to increase, and the scope of the firm is likely to increase.*

At first glance, Proposition 5 seems to be at odds with Propositions 1 through 4 and, more broadly, with the recent global trend toward liberalization and privatization. We invoke three arguments to make our case. First, new institutionalism suggests that history matters and that the short run is closer to history than the long run (North, 1990). Ingram and Silverman complain that "strategy often suffers from a tyranny of the here and now, a desire to celebrate contemporary phenomena and slight historical ones" (2002: 6). Although in the long run there perhaps may be a convergence, the historically derived emphasis on institutional relatedness in emerging economies is likely to continue to matter, at least in the short run.

Second, because organizations exist in and through time, it is possible that no theory or construct is truly "holochronic"—that is, a relationship exists independent of time (Zaheer, Albert, & Zaheer, 1999: 734). Although the construct of institutional relatedness may be nonholochronic, so, too, are virtually all our theories and constructs. This characteristic alone does not preclude this new construct from making a contribution. To make further progress, a necessary first step is "to make explicit the time scales implicit in existing work . . . by a full specification of all relevant time scales" (Zaheer et al., 1999: 739). Specifically, we have followed Peng's (2003) "temporal bracketing" approach by limiting our predictions for either the long run or the short run. Although such an approach may reduce the generalizability across time (both long run and short run), it "increases the precision of the predictions, at least within the specified period" (Peng, 2003: 17). This way of theorizing is in contrast with much existing strategy research, which "downplays temporal transitivity" (Ingram & Silverman, 2002: 6), but it may be more temporally informed and valid (Mayer & Whittington, 2003; Zaheer et al., 1999).

Finally, a better specification of what short run is helps make our case. Williamson (2000: 597) suggests an interesting classification: (1) 100–1000 years, (2) 10–100 years, (3) 1–10 years,

and (4) continuous (now). Williamson (2000: 608) argues that new institutionalism is primarily concerned with the second and third periods. If these two periods (1–100 years) are reasonable proxies of the short run, they seem to be a window of opportunity during which Proposition 5 may find some empirical support.

Globally, three sets of preliminary evidence broadly support the somewhat counterintuitive Proposition 5. First, throughout emerging economies, many conglomerates spearheaded e-commerce ventures and consequently expanded their scope in the 1990s. Second, conglomerates recently emerged in China and Russia for the first time, thus pointing to the *increasing* (not decreasing) importance of institutional relatedness, at least in the short run (Peng, 2000). Finally, in Chile and India, the scope of conglomerates actually *increased* during a period of rapid liberalization (Khanna & Palepu, 1999).

## DISCUSSION AND CONCLUSION

In this article we have focused on one of the four most fundamental questions in strategic management. The article contributes to our understanding of the scope of the firm question by highlighting the importance of institutional relatedness in an institution-based theory of corporate diversification. Earlier, Peng (2003) articulated how institutional transitions matter for strategic choices in general; we have extended this work by specifying under what specific institutional conditions a conglomeration strategy may or may not add value. Since “we need the frame-breaking experiences that only come from examining and comprehending organizations operating in other places and other times” (Scott, 1995: 151), we have integrated research not only from developed economies but also from emerging economies. Given the typical one-sided emphasis on product relatedness (which, of course, is still important) in the literature, it seems imperative that much more research investigate the important but often missed role of institutional relatedness in driving diversification decisions and outcomes both across time and around the world.

The limitations of the present article suggest a number of future directions. Perhaps the foremost limitation is a focus on the nature of the firm. The firm in developed economies has relatively clear legal boundaries (Williamson,

2000). The conglomerate in many emerging economies tends to have blurred boundaries (Peng & Heath, 1996). Such a firm is sometimes called a “business group.” The difficulty in identifying its boundaries has not only led to nontrivial measurement problems but also to conceptual debates on whether such an organization is a “firm.” Thus, future work needs to tackle this challenging problem.

Second, while researchers have experienced great difficulties in measuring product relatedness, measuring institutional relatedness, which is more informal, unique, and invisible, is likely to be much more challenging. For example, in Chile, Khanna and Palepu relied on “miscellaneous knowledgeable observers” (2000: 273) to identify group linkages. In Indonesia, Fisman (2001) used an idiosyncratic “Suharto Dependency Index” to measure firms’ connectedness with former president Suharto. These measures inevitably carry some “noise.” How to empirically capture an inherently invisible and socially complex resource such as institutional relatedness remains a significant challenge.

Third, for conglomerates in emerging economies, given the long-run needs to contract (Propositions 1–4) and the short-run incentives to expand the scope (Proposition 5), where the point of inflection is remains to be clarified (Peng, 2003). Further, geographical and technological scope (Delios & Beamish, 1999; Peng, 2006; Wright et al., 2005), while beyond the scope of this article, warrants further investigation.

Overall, the question “What determines the scope of the firm over time?” entails complex answers. We have attempted to capture some of this complexity by advancing and leveraging the notion of institutional relatedness. In conclusion, if this article could contain only one message, we would like it to be a sense of the staggering power of institutional frameworks and their transitions that help determine the strategic choices and performance outcomes for corporate diversification over time.

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