FONDAZIONE ARISTIDE MERLONI

Economia Marche Journal of Applied Economics

Vol. XXXI, No. 2, December 2012

Family Firms, Entrepreneurship and Economic Development

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Abstract

Family firms are usually seen as the cradle of entrepreneurship, as they are the best providers of the entrepreneurial business capital. A growing literature shows that family firms are extremely well-placed to assist economic growth in many activities in the private sectors, as they combine a number of unique sociological and economic characteristics that make them extremely important in the early stage of the growth of the firm. However, the way in which economic development produces changes in dominant family patterns has been advanced much more often than the view that family patterns can affect economic development. Therefore, much research is needed to make family firms a central focus in the theoretical and academic research and a crucial issue at the core of the political agenda.

JEL Classification: *G3; O12*

Keywords: *Family firms; Entrepreneurship; Economic development.*

Affiliations and acknowledgements

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Suggested citation

Cucculelli M. (2012), Family Firms, Entrepreneurship and Economic Development, Economia Marche Journal of Applied Economics, XXXI(2): 1-8.

Most businesses in developing and emerging economies tend to be small, and most of these small businesses are family owned firms, where children follow in the footsteps of their parents in producing and selling goods or services (Naudé, 2012; Szirmai *et al.*, 2011). Because of the predominance of these firms in developing countries (and also in advanced economies) it is often argued that family businesses are good for economic development. But does the fact that we observe so many people employed in family businesses mean that family businesses are drivers of economic growth and development?

Family firms are important, not only because they make an essential contribution to the economy, but also because of the long-term stability they bring, the specific commitment they show to local communities, the responsibility they feel as owners and the values they stand for. These are precious factors against the backdrop of the current financial crisis. Family businesses make up more than 60% of all European companies, encompassing a vast range of firms of different sizes and from different sectors. Most SMEs (especially micro and small enterprises) are family businesses and a large majority of family companies are SMEs (European Commission, 2009).

Family Firms are usually seen as the cradle of entrepreneurship, as they are the best providers of the entrepreneurial business capital. Entrepreneurship is a necessary condition for economic growth and development. Modern states converge in treating entrepreneurship as a key economic resource; and entrepreneurship is especially important in the period of structural change and changing global division of labour. As different parts of the world are experiencing dramatic changes from economic fluctuations, government revolutions, technological innovations, and generational transitions, understanding the role of SMEs and family firms in sustaining entrepreneurship is a crucial issue for advance in economic development. Hence, the need to links these two issues is crucial to have a better understanding of the process of economic development.

This issue of *Economia Marche* Journal of Applied Economics is devoted to the topics of entrepreneurship and family firms. It collects eight papers selected from the Conference on "*Entrepreneurship, Family Firms and Economic Development*" held in Cracow, Poland on April, 27-28 2012. The Conference has been co-organized by the Cracow University of Economics and the Faculty of Economics "Giorgio Fuà" - Università Politecnica delle Marche, and sponsored by the International Council for Small Business (ICSB) and the European Council for Small Business (ECSB).

As illustrated in more details by almost all the papers in this issue, a growing body of work indicates that economic growth depends on the distribution of control over capital assets. But why are family firms so prevalent? What are the implications of family control for the governance, financing and overall performance of these businesses? These questions are only beginning to receive attention in the economic research community (Bertrand and Schoar, 2006). At the core of the debate is the question of whether family firms evolve as an efficient response to the institutional and market environments, or whether they are an outcome of cultural norms that might be costly for corporate decisions and economic outcomes. The idea that a culture based on strong family ties may sometimes impede economic development is not new. Such a view dates back at least to Max Weber's 1904 essay, which argues that strong culturally predetermined family values may place restraints on the development of capitalist economic activities, which require a more individualistic form of entrepreneurship and the absence of nepotism; Banfield (1958) who described the "amoral familism" in the south of Italy as one of the main reasons for the smaller average firm size and slower economic development of the south relative to the north; Fukuyama (1995), who puts forth that in societies where people are raised to trust their close family networks, they are also taught to distrust people outside the family, which impedes the development of formal institutions in society. Under such a cultural view, suboptimal economic organizations can emerge when parents put too much weight on keeping the business in the family, maybe due to a strong sense of duty towards other family members or a more selfish desire to turn the business into a family legacy (Bertrand and Schoar, 2006).

The claim that family patterns may have an impact on development represents a reversal of the more usual argument. We have abundant research on the way in which economic development produces changes in dominant family patterns in societies around the world. Often, the family is seen as a relatively passive institution, buffeted and altered by powerful economic and political forces. The view that family patterns can affect whether and how rapidly economic development occurs has been advanced much less often, but it will be a central focus in the empirical agenda (Whyte, 1996).

Since the early work on family firms and development, economic planners have commonly assumed that family firms are detrimental to economic development because they are based on nepotism and paternalism which foster inefficiency.[1] But the reality of data show that this model of governance is actually among the most diffuse worldwide. A growing literature shows that the private sectors, as represented by the family firm, is an important growing point in the economies, especially of low income countries. It does not claim that family firms are suitable for every sort of enterprises required by a developing economy, but that for commerce, industry and many types of financial activity they are extremely well-placed to assist economic growth because they combine a number of unique sociological and economic characteristics that make them extremely important in the early stage of the growth of the firm than in the later stages.

Because of this, family firms have gained the centre of the recent empirical literature on ownership and performance as the typical firm is owned and, frequently, managed by a family. Family firms are widespread around the world and are also correlated with significantly more variation than other firms in measures of economic output and firm value (Bennedsen *et al.*, 2010). This is mainly due to the peculiar trait of family governance, which reflects the dynamic interplay between owners' values, organizational history and value-maximizing policies required by the industry competitive conditions (Zahra, 2005). The long-term nature of family ownership allows families to invest in innovation and risk-taking, thereby empowering these firms with the potential to be able to innovate and pursue entrepreneurial activities. Yet, some family firms become conservative over time, unwilling or unable to take the risks associated with entrepreneurship (Gómez-Mejía *et al.*, 2007), or more inclined to appoint descendants as company CEOs (Pérez-González, 2006). This may curb the firm's entrepreneurial attitude and even impede economic development (Morck *et al.*, 2000).

Economists have viewed families as entities that produce and organize multiple activities. As families make decisions that maximize the welfare of the family, the joint maximization of family and business objectives often entail gains in one sphere at the expense of the other one (Bennedsen *et al.*, 2010). Empirical literature has shown that family ownership has important implications for corporate management and performance (Shleifer and Vishny, 1997). Despite

[1] A curious empirical observation reported by Morck *et al.* (2000) divides up the world's US dollar billionaires into two categories –self made billionaires and billionaire who inherited their wealth – and sum up the wealth owned by each category of billionaires in each country. Unsurprisingly, they find that a country's per capita GDP grows faster if its self-made billionaire wealth is larger as a fraction of GDP. What is surprising is their result that per capita GDP growth is slower in countries where inherited billionaire wealth is larger as a fraction of GDP.

the potential advantages attributed to family ownership, López de Silanes *et al.* (1999) warned that concentration of wealth in a single firm leads to greater risk-aversion in family firms and, in aggregate, this desire to minimize business risk can induce them to select risk-avoiding projects with a detrimental effect on overall economic development. Moreover, the tendency to preserve their financial and socio-emotional wealth for future generations can lead family firms to select investments with shorter payback periods, less risky cash flows and more pledgeable assets, thus making underinvestment incentives very likely to be observed in these firms (Almeida *et al.*, 2011).

Family ownership is often associated with a double role for the family as that of owners and managers of the firm. In economic terms, families make firm-specific investments in human capital, which makes them reluctant to give up control. This, and the fact that typically a higher share of the owner's wealth is invested in the firm, creates a long-term commitment to the survival of the company and results in family firms being more risk-averse than other firms. Hence, their behaviour may be affected by a high sensitivity to uncertainty and by a risk attitude which induce them to avoid decisions affecting the firm's survival or the stability of control (Thomsen and Pedersen, 2000; Villalonga and Amit, 2006; Cucculelli and Marchionne, 2012). Gómez-Mejía *et al.* (2007) provide convincing evidence that risk affects family management in a very peculiar way. As family firms give priority to the "socio-emotional wealth" that they obtain by controlling the company, they are more likely to accept greater performance hazard to mitigate the loss of the socio-emotional endowment. However, this willingness emerges only when the socio-emotional endowment is considerably at risk. Conversely, family firms are less likely to take on risky projects, i.e. projects with high outcome variance such as those that involve the search of alternative routines or new opportunities (venturing risk) to change the status quo. Gómez-Mejía *et al.* (2007) conclude that family firms are just as rational as non-family firms when it comes to taking risky business decisions. Yet, the criteria for judging whether the decision is risky vary by the two types of firms: for families, a key criterion is whether their socio-emotional endowment will be preserved; for non-family firms, financial criteria seem to be most important when they assess the value of a business decision. Finally, some evidence on the role that risk preferences play on a firm's decisions can be found in the literature on the sectoral distribution of family ownership. These studies show that family firms are relatively less frequent in sectors with high capital intensity and scale (Bennedsen *et al.*, 2010), as well as in those sectors where family firm-specific investments are not crucial, as in rapidly evolving industries or in R&D-intensive industries (Pérez-González, 2006), or in markets that are larger in size (Demsetz and Lehn, 1985; Villalonga and Amit, 2006).

To sum up, we resume the same old question: are family firms the real sources of productivity growth and innovation, which are the foundations of the economic development? Or are they perhaps manifestations of some weaknesses in markets and institutions? The short answer(s) to the above questions follows from the fact that entrepreneurs - and in particular family businesses - are very heterogeneous (Naudé, 2010; Szirmai *et al.*, 2011). The diversity in entrepreneurship and family businesses is significant – and has contributed to confusion over definitions and measurements. Moreover, when researchers try to gauge the effects of family businesses and entrepreneurs in general on economic development, they tend to focus on the average or 'representative' firm (Naudé, 2010). The problem is that a large body of empirical research has by now established that the average firm do not spend more on innovation, in fact create lower quality and less secure jobs, and do not contribute that much to productivity growth. As Stam and Wennberg (2009) pointed out that the majority of new firms neither innovate nor grow, nor intend to do so'. The same holds for the average family business (Naudé, 2010). A rich literature has established that family businesses tend to be (i) smaller in size and market value, (ii) more risk averse, (iii) less innovative (iv) less productive (v) less international, (vi) less inclined to do Corporate Social Responsibility; they are also more characterized by poor management practices (Szirmai *et al.*, 2011).

Instead of being discouraged by these results, Naudé (2012) suggests we should rather consider that many interesting phenomena need to be better understood that may throw better light on the role of family businesses in development. For instance despite the fact that the average family business is not likely to be a driver of economic growth, there are indeed exceptional firms that do make such contributions. Many family firms are innovative; many create a demand for highly skilled labour; many provide essential gap-filling inputs and goods. Moreover the family business seem to be better at handling difficult or complex labour relations, tend have a more long-term perspective to business and investment, and tend to encourage portfolio entrepreneurship (Sraer and Thesmar, 2007). These latter contributions suggest that the prevalence of family firms may be a response to a lack of well-developed market institutions, but also the lack of trust or weak institutional environment (Naudé, 2012; Bertrand and Schoar, 2006). Therefore, understanding why and how family firms contribute to economic development and growth is therefore important in each context for informing entrepreneurship policy not only in developing countries and emerging markets, but also in developed countries (Naudé, 2010). This are the reason why the organizers have designed the Conference as a meeting point to discuss past, present and future tendencies with regard to entrepreneurship and family firms and their impact on economic development.

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Imprese familiari, imprenditorialità e sviluppo economico

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Sommario

Le *family firms* sono considerate la culla dell'imprenditorialità per la loro capacità di generare il capitale umano imprenditoriale che è alla base della crescita economica e dello sviluppo. Una rilevante letteratura mostra che le *family firms* sono particolarmente efficaci nel sostenere la crescita di numerose attività economiche di natura privata, grazie alla loro capacità di combinare caratteristiche sociologiche ed economiche particolarmente importanti nelle fasi di avvio dell'impresa. Tuttavia, la letteratura ha prodotto maggiori risultati sul modo con il quale lo sviluppo economico influenza i modelli sociali di famiglia piuttosto che su come le *family firms* possono sostenere lo sviluppo economico. Per tale ragione, si ritiene esistano ampi spazi per mettere le *family firms* al centro della ricerca accademica e dell'agenda politica.

Classificazione JEL: *G3; O12*

Parole Chiave: *Imprese familiari; Imprenditorialità; Sviluppo Economico.*