Although family firms are widely praised as the 'backbone of the economy', their productivity is often hampered by weak management. Research by **Daniela Scur** and **Renata Lemos** provides new evidence on the performance of 'dynastic' family-owned firms and explores why those led by family bosses adopt fewer structured management practices.

Family firms:

the problem of second-generation bosses

Family firms are the most prevalent type of firm in the world. This is especially true in emerging economies, where they account for over half of medium-sized firms in the manufacturing sector. Indeed, a quarter are 'dynastic' family firms – those in which the founding family owns a controlling share and which have appointed a second-generation (or later) family member as the chief executive officer (CEO).

How do these firms operate and what is their impact on the economy and labour markets? Although there is mixed evidence on whether family ownership of firms is a good thing, the weight of the evidence is that dynastic family CEOs are usually bad news for productivity. But why is that the case?

Poor management practices have been widely shown to be an important influence on productivity. Our study presents the first causal evidence that dynastic family firms have worse management practices. The extent of this bad management is broad, implying a possible productivity hit of 5 to 10%.

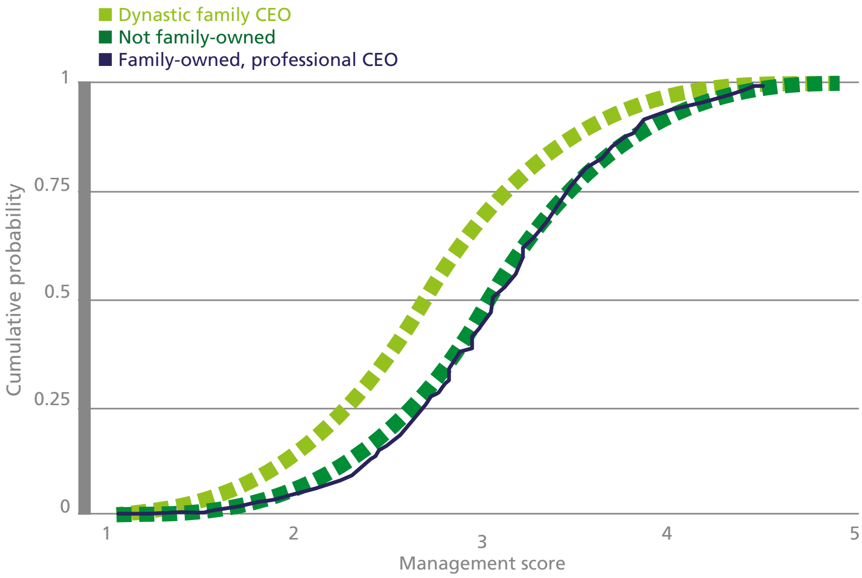
But if better management practices lead to better firm performance, why are CEOs not adopting them? To consider the reasons behind this managerial underperformance, we explore how family firm-specific 'reputation costs', which seem to push first-generation CEOs to do better, might act as a constraint on adoption of innovative management processes by second-generation CEOs.

Despite the global prevalence of family firms, research on this topic is often stymied by a lack of good data on private firms. One large project that has worked to remedy some of this gap is the World Management Survey (WMS).

The WMS uses a survey tool covering 18 management topics scored on a scale of 1 to 5 (worst to best). With over 15,000 data points in the worldwide dataset, one stubborn pattern keeps on cropping up: family firms are consistently placed in the bottom of the management quality rankings.

Dynastic family-owned firms have worse management practices, but only if they are run by family CEOs

Figure 1:
Firms run by dynastic CEOs tend to have worse management



Note: World Management Survey data. Excludes founder-owned firms. N=11,857; N(not family-owned)=8,592; N(family-owned, professional CEO)=565; N(family-owned, family CEO)=2,700.

Figure 1 shows the cumulative distribution of management scores for firms run by dynastic family CEOs, firms run by a professional CEO but owned by families, and all other non-family firms. What is immediately obvious is that family ownership does not seem to be an issue per se. Rather, the difference seems to be driven by the choice of CEO. But how should we address the question of the direction of causality between management quality and choice of CEO in succession decisions?

Previous research has either focused on public firms or exploited the rich datasets of Denmark. To help address the endogeneity inherent in succession decisions, we developed a new survey to collect data on the history of succession of ownership and control, as well as family characteristics of family CEOs.

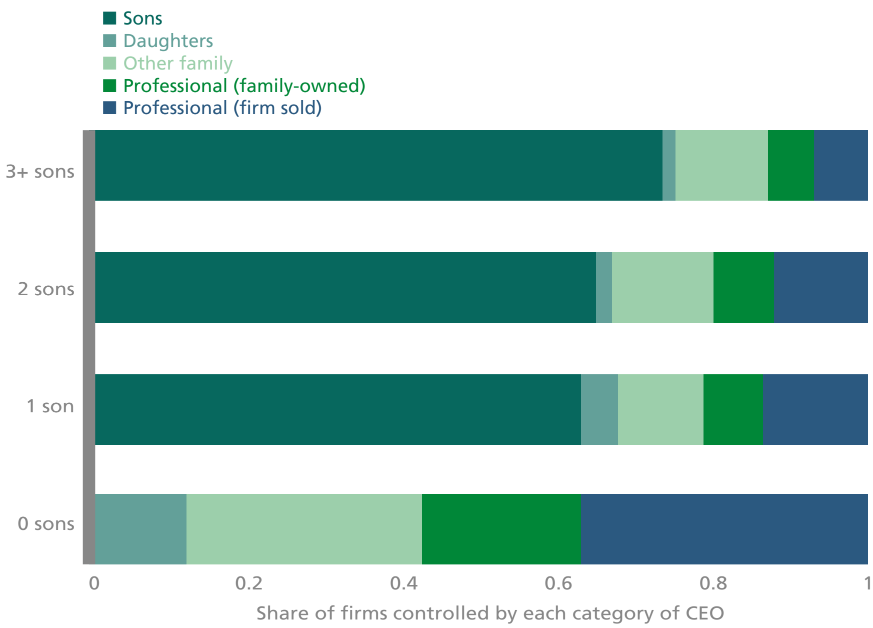
We used the WMS sample of firms and interviewed over 2,700 firms in 2013 and 2014, though a large share of these firms were still first-generation founder firms or had not been founded by a single family or founder. At the end, a total of 810 firms from 12 countries had undergone at least one succession originating from a founder or family firm at the time we interviewed them.

To identify the causal relationship between dynastic CEO successions and management quality, we used the following approach. Given the total number of the outgoing CEO's children, the number of them that happen to be boys is as good as random. This gives us an instrument for dynastic CEO successions: we find that outgoing CEOs who have at least one son are about 30 percentage points more likely to keep the firm in the family than those who had no boys.

Figure 2 depicts this pattern: for each category representing the number of sons of the outgoing CEO, each block indicates the identity of the new CEO. Assuming that the gender of the outgoing CEO's children is unrelated to their choices of management practices, we find that

> Family firms could hire professional CEOs, but there are often institutional constraints, particularly in emerging economies

Figure 2:
Outgoing CEOs who had at least one son are more likely to keep the firm in the family



Note: 'Other family' includes primarily male family members such as grandchildren, nephews, in-laws etc. This graph includes all successions included in the sample used for the analysis. N=818.

The ‘reputation costs’ for family firms of firing workers may deter them from adopting better management practices

This article summarises Daniela Scur’s job market paper ‘All in the Family: CEO Choice and Firm Organization’, co-authored with Renata Lemos of the World Bank and CEP research associate.

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a succession to a family CEO leads to significantly worse management practices relative to firms with successions to non-family CEOs. But why might that be?

The second part of our analysis focuses on understanding why firms led by family CEOs adopt fewer structured management practices. There are a number of reasons underlying the difficulties in effecting organisational change. The two mechanisms often ascribed to family firms relate to lower levels of skills and lack of awareness of managerial underperformance. While relevant, neither of these mechanisms fully explains the gap in management underperformance.

We propose a different explanation based on the wealth of evidence suggesting that family firms have implicit employment commitments with their workers. Evidence of such commitments includes providing better job security as a compensating differential for lower wages and firing fewer employees when hit by negative productivity shocks.

In our analysis, we propose that because of these implicit commitments, family CEOs incur ‘reputation costs’ when firing workers. If we think of management as a monitoring technology that allows CEOs to observe their workers’ productivity, it is only worthwhile to invest in the technology if the CEOs then use the information to discipline the low-productivity workers. Thus, the ‘reputation costs’ incurred by family CEOs may act as a constraint on investing in this technology.

We find empirical support for the predictions of our analysis.

A naive solution could be that all family firms hire professional CEOs. But that would be an unrealistic prescription given the institutional constraints that bar many firm owners in emerging economies from pursuing this avenue. For example, there are often shortages of managerial talent or weak legal systems that might fail to protect owners from devious CEOs. Owner-managers might also simply prefer being their own boss.

So, if we accept that family control is the necessary (or preferred) control structure for many firms, it is crucial to understand what may be the barriers to investment in better management practices within family firms.

While policy-makers can seek to improve the environment to allow firm owners to consider hiring professional CEOs, family firm CEOs can also tackle some of the following issues:

- The first prescription is to go through an honest self-diagnostic: the WMS website has a tool that allows for self-evaluation as well as national and industrial benchmarking.
- The second prescription is to take the identified bottlenecks from the self-evaluation tool to fix the issues. If it is not immediately obvious how to do it, there are a number of online resources that can help improve management skills.
- Third, acknowledging that the relationship between family CEOs and their employees is distinct from other firms, it is important to involve employees in the process of organisational change so that change can be long lasting. In particular, it is important to understand that improving monitoring in the firm can be useful even if dismissing employees is not an option – there are still a number of employee improvement policies that can be enacted once the diagnosis is made.

Our research is innovative in two main ways: first, we show the first causal evidence that dynastic family CEO successions lead to worse management.

Second, we go beyond the usual suggestions of improving information and skills, and suggest that the specific labour context in which family firms act is important.

We propose that the implicit employment commitments between family managers and their workers should factor in both how projects to upgrade management are presented to prospective firm managers, as well as the expected take-up and long-term adherence of such improvements. This is a key consideration as many organisations around the world push forward in enacting management upgrading projects.

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