A Transaction Cost Rationale for Transition of the Firm within the Family

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ABSTRACT. This paper is about the transition of ownership of shares in small and medium-sized enterprises (SMEs) within the family (i.e. from parents to children). In spite of the fact that such successions are rather prevalent among SMEs, there are no explanations in the literature as to why transitions are preferred to outright sale.

In this paper we assume that the decisive factor in the choice of succession mode is the desire for efficiency expressed as the highest possible firm value. A firm should stay in the family if this is the most profitable transition alternative. One reason for intergenerational succession to be the most profitable alternative is knowledge idiosyncrasy.

However, the benefits of knowledge idiosyncrasy cannot be reaped without an institutional framework that constrains human activities in a proper way. A part of an institutional framework are the laws that act as constraints in successions. Do these laws foster or prevent efficient transition of family firms? This question is addressed in a study of the Swedish inheritance and inheritance tax laws in the light of the policy recommendations on succession made by the European Commission.

1. Introduction

In most countries a majority of the firms are not listed on a stock exchange. Many of these non-listed firms are family-owned and there are plans for the children in the future to take over the ownership, and perhaps also the management. Furthermore, some of these firms have already been family-owned for more than one generation. That firms stay within the family for generations has not received much attention in the economics literature. There seems to be a lack of theoretical explanations as to why a succession of firms to heirs would be rational.

The question addressed in this paper is: "Are there any beneficent reasons why firm value would be positively affected by succession instead of the sale of a family firm to new non-family owners?" A transaction cost-approach will be used to show why there are such efficiency reasons for inter-generational transitions of firms. This approach will also be used in a discussion of how well the Swedish inheritance and tax laws are adapted to foster efficiency reasons for succession within the family.

Transition of family businesses within the family can be studied from three major angles. Succession of ownership of shares; transition of leadership in the family firm; and the influence of the family (e.g. through a family board) on the transition process. We limit this paper mainly to questions concerning succession of ownership.

Transition of ownership can, and sometimes should, be made to outsiders. We concentrate on transitions within the family and we also give arguments why this should be preferred and promoted by legislative efforts. A transition within the family can be planned and carried out during the lifetime of the owner or left to be decided upon his or her death. We concentrate this paper on certain aspects concerning transition of ownership of shares through inheritance. Furthermore, we limit the discussion to mainly the Swedish inheritance and inheritance tax law systems.

In order to achieve these objectives the study is structured as follows. We begin in Section 2 with a short background and the policy recommendation of the European Commission. Section 3 presents our transaction cost approach to the

Final version accepted on March 12, 2001

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Small Business Economics **19**: 123–133, 2002.

problem of succession. The Swedish legal system and taxes that provide the institutional framework for succession through inheritance are described in Section 4. How well the Swedish inheritance law and tax system foster efficient successions of family firms is discussed in Section 5. The paper ends with a summary and concluding remarks in Section 6.

2. A short background and the EU recommendation

In 1998, there were almost 20 million non-primary private enterprises in the European Economic Area. Almost all were SMEs employing fewer than 250 people. The share of SMEs of total employment was almost 70%.[1] SMEs have thus the biggest potential of creating new jobs. Of all petitions for bankruptcy in the Community, an estimated 10% are filed as a result of badly managed successions. These threaten at least 30,000 enterprises and 300,000 jobs every year.[2] It has been estimated that about 6.3 million jobs in Europe are threatened in the near future because of poor preparation for the transition of businesses.[3]

A study from the United Kingdom showed that only 24% of family businesses were transferred to the second generation and that a mere 14% survive to the third generation.[4] On the other hand, research results seem to show that if a business survives to the second generation, the probability that it will also survive the following transitions increases substantially.[5] Of the less than one third of the family business that were included in a study and which survived the transition to the second generation, approximately 50% survived from the second to the third generation and more than 70% of these firms were passed on to the fourth generation. The higher degree of survival can, among other reasons, be a result of the experiences of the first succession, e.g. that the next generation has worked in the company and that a succession has been initiated, planned and carried through in due time.[6]

Studies within the Community show that a majority of the entrepreneurs have not taken the necessary steps to plan and carry out coming successions. As an example, a study of 35 family businesses in England shows that only about 25% had chosen a successor to the present CEO.[7] Around one third of the owners of small companies in the Community are over fifty years of age.[8] It therefore seems urgent to find measures that facilitate successions.

Research on transfer of ownership in companies shows that there are four main problems that hamper an efficient change of ownership. The first difficulty is the valuation of the enterprise. Second, financing the take-over can be a bottleneck. The legal dispositions are the third problem. Taking account of various legal arrangements, e.g. inheritance, company and taxation law is crucial when preparing a transition. Last, but not least, the personal and emotional aspects can give rise to various difficulties.[9]

The European Commission is aware of the main problems concerning succession. It recommends a number of solutions in the legal and fiscal field. In 1994, the Commission issued a non-binding recommendation, since the member states have varying legal and other conditions of importance for transfer of enterprises.[10] The recommendation contains 10 articles. A few of them are briefly dealt with in the following:

The survival of the enterprise within a family should be ensured through appropriate fiscal treatment of succession and gifts. Member states are invited to (art. 6):

a) reduce the taxes on assets exclusively used for the business in the case of transfer by gift or succession, including inheritance tax, gift tax and registration fees, provided that the business is genuinely kept as a going concern for a minimum period;
b) offer the heirs the possibility of spreading or deferring payment of the gift or inheritance taxes, provided that they keep the business as a going concern, and shall grant interest exemptions;
c) ensure that the tax assessment of the business can take account of how the value of the business changes some months after the death of the owner.

For families who wish to make transitions of the shares in the companies during the lifetime of the owners, businessmen should be provided with appropriate instruments, which will allow the best preparation of transfer. To this end, the

Commission requests the Member States (art. 4):

a) independently of the obligations stemming from Community law, (to) apply the principle of fiscal neutrality to operations for the preparation of transfers such as transfers of assets, mergers, divisions and exchanges of shares; the principle of fiscal neutrality shall also apply to stamp duties, registration fees and other similar taxes.

These methods are, however, dealt with in another paper (Bjuggren-Sund, 2000). Here we concentrate on various aspects of inheritance of a family business.

The EU-recommendation (art. 6) more or less takes as given that there are advantages of inter-generational family succession. But is such an assertion justified? As far as we know, there are no coherent theories that can guide us.

3. A transaction cost approach to transition

3.1. *Knowledge idiosyncrasy*

In all family firms the problem of succession has to be faced at some point. When that time comes, the decision to let a younger generation of family members take over or sell to new non-family owners has to be made. A lot of different factors of a pecuniary and non-pecuniary character may be influential in the choice between these alternatives. To simplify matters, we will here make the assumption that the objective in a succession decision is to maximise wealth. Decision factors of a more sentimental character will thus be disregarded. The decision problem in successions then boils down to a question of under which circumstances is it likely that the present value of a firm is higher in a succession of a firm to heirs than what can be received in a sale to non-family owners.

In answer to this question an explanation must be provided of how firm value can be fostered by a transition within the family. The analysis of the problem has both a macro and a micro dimension. At a macro level, norms, laws (taxes and other types of influential laws) and regulations that constitute the institutional framework, within which succession transactions take place, are considered.[11] The institutional framework will differ between countries and regions. This macro aspect of the succession problem in a specific country, Sweden, will be addressed Sections 4–6. Instead, the analysis here will be made under the assumption of a given institutional framework. In other words, there is a focus on the micro aspects of the succession problem. The institutional framework is assumed as given.

In a micro-explanation two key elements are knowledge idiosyncrasy of a family character and uncertainty/complexity. These are two factors of a transaction environmental character that are likely to be decisive in the choice of succession mode.[12] Special attention will be paid to knowledge idiosyncrasy as the central explanatory variable. Knowledge idiosyncrasy possessed by a family member is claimed to be the basic reason for transition within the family to be a wealth maximising strategy.

Family idiosyncratic knowledge is acquired in a learning by watching and doing fashion. Growing up with the owner entrepreneur of a family firm gives an inside position that may give specific knowledge of how to run the firm in a profitable way. In many trades of a more craftsmanship character this knowledge is, to a large extent, tacit. It is acquired over time by observing and listening to the older generation and by practising what thereby has been learned.[13] The younger generation is in a unique position to acquire such idiosyncratic knowledge. They spend most of their time with parents-entrepreneurs. They see them at work and listen to the discussions of the firm's problems within the family circle. The discussion in such an environment is likely to be more candid than in other circles. The family members can trust each other and are more likely to reveal secrets to a larger extent.

Illustrations of how the learning by watching and doing take place are provided in the management literature. The process character of succession from one generation to another is stressed. Reviews of this literature can be found in Dyer and Handler (1994) and Brunåker (1996). Both these overviews depict a similar pattern with a gradually increasing involvement of the family member in a process that if it is planned ends with the next generation family member being the decision-maker and the predecessor the consultant.

In an unintentional succession due to the predecessor's death the process will, of course, be more abrupt.

Among the reviewed studies, Longenecker and Schoen (1978) can serve as an illustration of how idiosyncratic knowledge is acquired. The different stages in a father-son succession are described. Before being the manager and finally de facto leader of the family firm the successive stages of learning are characterised by terms as "aware of some facets of business, exposed to family members' jargon, works part time in business, works full time in business with non managerial jobs" (Longenecker and Schoen, 1978, p. 4). In Handler (1989) these stages of successive learning are characterised by terms as "No Role, Helper, Manager and Leader".

An historical study of how family succession in an American textile company, the Doak Company, was planned through education and business experience is provided by Scranton (1986). Besides a detailed description of how the heir in question was trained in education and practice, Scranton also makes a remark about the fact that the gradual involvement of offspring in the family business does not have to result in succession. "Fathers could evaluate their sons' prowess and potential, their effectiveness and aptitude for directing the firm. In the worst case, a decision to "sell out" might be reached as an alternative to certain ruin of the business by an inept successor" (p. 61). In other words "sell out" could be chosen if succession within the family despite acquired idiosyncratic knowledge did not turn out to be a wealth-maximising strategy.

There is also idiosyncratic knowledge of a network character that is likely to be acquired by growing up within a family business that will be further developed in the next section. The argument is that good personal relations with a well functioning business network can be inherited since customers, suppliers and businessmen within the same trade tend to know all the members of the family and learn also to trust the family members through these encounters.[14] It is also to be expected that offspring will be concerned about not tarnishing the reputation of their parents. Consequently, the new generation can, in many cases, start their work in an environment of trust that facilitates business transactions in a way that is not immediately available to others.[15]

In the choice between letting the new generation take over or "sell out" there is an incentive problem of a principal-agent character that must be addressed. This incentive problem is of special importance if there is idiosyncratic knowledge that is possessed by only family members. In such a case, the only way to take advantage of benefits from idiosyncratic knowledge is to have the firm managed by a member of the original entrepreneurial family. The two alternatives of interest will be (1) a succession of the firm to a family member or (2) an arrangement where the firm is sold to an outsider with a son/daughter remaining in the firm as a salaried manager. The succession problem in the choice between these alternatives boils to down to the question of the incentive effects of a separation of ownership and control. Will the value of the firm be affected by the son/daughter being just a salaried manager instead of both owner and manager?

The classic article by Jensen and Meckling (1976) provides an answer. The manager will behave differently as a salaried manager (agent of the new non-family owners) than in the roles of sole owner and manager combined. As an agent he/she will be less interested in running the firm in a value increasing fashion. Opportunistic behaviour expressed by using the resources of the firm to one's own private advantage will be more interesting as the costs of such consumption on the job will be shared with the new outside owners.[16] The more complexity and uncertainty about future events that characterise the operations of the firm, the more leeway for opportunistic behaviour of this sort there will be and the more negatively firm value will be affected by a change of ownership to outsiders. This fact reinforces the argument that idiosyncratic knowledge of family members is likely to be a very important reason for succession of firms within the family.

However, even if sons and daughters might be in a superior position of acquiring idiosyncratic knowledge about how to run the business successfully and have unique access to important network relations within the business society, it is not certain that their capacities, aptitudes and talents will match these advantages. The best man/woman as a leader of the firm may have to be found outside the family circle because of a lack of these virtues. In such an instance, sale of the firm will be more attractive than succession of the younger generation.

The complexity of certain types of business and the uncertainty about the future often means that there is an asymmetry in the information available to the different parties in a transaction. The presence of asymmetric information about the firm value (represented by the present value of the expected cash flows from the assets of the firm) is a factor of special importance for the transition decision of family firms. The present owners are likely to have superior information about how large these cash flows can be expected to be. A family firm is in general not listed on a stock exchange. Consequently, there is up to the time of succession no outside estimation of cash flows and firm value. The information gap between outsiders and the insiders, the family owners, is therefore wider than in other cases.

In sales to outsiders an Ackerlof type of "lemon problem" has to be solved.[17] When the information gap between insiders and outsiders is wide the transaction costs of transmitting information about the firm value will, in some cases, be so large that it is impossible to get a fair price for a family firm with respect to present value of expected cash flows. As a result there will be no functioning market for sales of family firms. In some cases, it might only be possible to receive the liquidation value in a sale.

3.2. *How does the institutional environment matter?*

In the previous section the heritage of idiosyncratic knowledge from one generation to another was stressed as the important factor in an explanation of family succession of firms. It was hinted that there is a connection between the institutional environment of the firm and the idiosyncratic knowledge possessed by offspring. It was also said that the institutional environment could differ between areas of different geographical size, i.e. between regions as well as countries. In an explanation of how institutional environment and idiosyncratic knowledge in succession matters, two aspects of the institutional environment are thereby of special importance. Firstly, the institutional environment at the local level in form of rules for human conduct can be of a type that makes idiosyncratic knowledge a very important factor in achieving competitive advantages. Secondly, the institutional environment on a larger jurisdictional level as the state/federal/country level can be of a kind that either fosters, prevents or does not affect the spontaneous emergence of the above-mentioned rules of conduct at a local level favourable to family succession.

Before going into a discussion on these two aspects, what is meant by an institutional environment or an institutional framework first has first to be defined.[18] The institutional framework (the institutional environment) can be defined as "constitutions, statutes, regulations, norms, enforcement, and sanctions" that "constrain and direct" economic actors (Eggertson, 1996, p. 8).[19] In other words, the institutional environment, or framework, consists of both formal rules in the nature of different kinds of laws, and informal rules in the nature of norms. It is also to be noted that "the institutional framework defines and limits the set of practicable forms of economic organisation available to actors" (Eggertson, 1996, p. 10).[20]

It is the informal rules that are of interest when considering how idiosyncratic knowledge about important local and other conditions are created in family firms belonging to a special industrial district, such as Gnosjö in Sweden or the Third Italy.[21] Let us look at the informal rules and see how this process works. Like formal rules the informal rules impose constraints on the behaviour of people in their relations to others. Types of informal rules constraining us in our relations are "codes of conduct, norms of behaviour and conventions".[22] North (1990) claims that these informal constraints are part of what we call culture and this culture is transmitted from one generation to another via teaching and imitation.[23] Dense social networks provide an especially fertile soil for the emergence of stable and influential informal rules.

Informal rules in social networks facilitate transactions by solving prisoner's dilemma problems in business relations. It will be in the interest of the parties in such a society not to cheat in their dealings with each other. The gain from cheating in a transaction will be small compared to the present value of the resulting losses in future transactions. It will simply not pay to cheat or behave opportunistically in business transactions within the network. This will especially be the case if an infinite number of future transactions within the network is envisioned. Links between generations within the same community constituting a social network provide a way through which the time span in relationships and dealings is made indefinite.[24]

The co-operation within the network can take different forms. One example could be that small firms help each other in those instances where there is temporarily a shortage of capacity. They can borrow tools from each other, use each other's workforce, help each other with expediting a large order, and so forth.[25] Some sort of tit-for-tat reasoning à la Axelrod (1984) is likely to govern such co-operation. "If I help you today I expect you to provide me with similar assistance in the future (when I need it)". With strong family ties, this social game is played an indefinite number of times. Besides self-enforcing mechanisms of this sort, there are a number of social ties or bonds that also serve as a means of enforcing co-operative behaviour. The community members are members of the same church, clubs and guilds. In industrial districts like Gnosjö and Third Italy, social and business concerns are intertwined in personal networks.[26] Revealed opportunistic behaviour will therefore be very costly.

Shared norms and no incentives to cheat facilitate transactions. Problems due to pairing of complexity/uncertainty and opportunistic behaviour are largely reduced. This will be reflected in cost advantages relative to competitors outside the network. Short-term contracts will be the transactional mode chosen within the network. Vertical integration and hybrids of market and firms as different types of long-term contracts are not necessary as safeguards in transactional relations as agreements are self-enforcing. These transactional advantages might, among other things, be reflected in higher profits for firms within the network.[27]

In communities of this character, with dense business and social networks, the inhabitants are, to a large extent, entrepreneurs in the sense of running their own small firm instead of being employed. This is, of course, a consequence of the large number of small firms.[28] The number of start-ups of new firms per thousand inhabitants is also high.[29] One explanation to this pattern is that every new generation in such a society learns how to run a firm, get specific knowledge of the parents' business, learn from early years the informal rules, and are also accepted as member of the social network early on. Succession of firms within the family is one way by which these advantages are utilised. Starting a new firm is another.[30] The hypothesis is that we can expect to find a larger number of intergenerational successions of family firms to heirs per thousand inhabitants in communities with many small firms and dense social networks than in other communities.

Let us now look at the impact of the formal rules on intergenerational idiosyncratic knowledge. The formal rules constraining economic behaviour can serve as complements that promote the efficiency of informal rules or have the opposite effect of weakening and changing informal rules (North, 1990, Ch. 6). Laws, regulations and taxes are examples of formal rules. These rules are, to a large extent, determined by political decisions in jurisdictions encompassing the whole country or regions of differing size. The outcome of the political process through which the formal rules are decided and implemented is of relevance for choice of means of succession in family firms. Taxes, inheritance laws and business policy in general can make intergenerational succession unattractive in spite of the network and other idiosyncratic knowledge advantages of continuing to run the firm with unchanged family ownership. Some observations of how Swedish laws can be expected to influence the succession decision is the subject of the next two sections.

4. The Swedish inheritance and tax laws

Given that a transition has not been planned and executed during the lifetime of the owner, the optional rules of the Inheritance Act normally dictates the succession conditions. This section is devoted to a description of the Swedish inheritance and inheritance tax laws. Section 5 analyses whether the system has an impact on the possibilities to keep ownership of the shares in the family business within the family.

When an unmarried entrepreneur dies intestate, the estate is inherited by the children, or in the case of them being deceased, by the grandchildren. If the entrepreneur has no descendants the parents or, if one of them is dead, the siblings or, if any of them is deceased, the nephews and nieces will inherit the estate.

The total inheritance consists of the net fortune, including the value of the shares in the family firm, less inheritance tax. The total value and the property are distributed among the heirs according to agreement or, if they cannot agree, in accordance with the Inheritance Act. If the heirs cannot agree, e.g. on distribution of the property, a court can appoint a person to divide the property.

If the deceased was married, the first step is a division of the matrimonial property. According to the main rule the surviving spouse takes half of the total net value of the marital property, including the shares in the family firm. We assume all property to be marital. Thus there is no separate property, which is not included in a division. Property can become separate through a marital property settlement or due to conditions in a will or a gift from a third party. The marital property is distributed according to agreement between the surviving spouse and the heirs. The heirs have a right of priority to the property, which was owned by the deceased spouse, e.g. the family company. If they cannot agree, a court can appoint a person to distribute the property.

According to the main inheritance rule, the surviving spouse inherits all the estate (after division of the matrimonial property), if the deceased spouse left no will. The children born into the relationship inherit from their deceased parent only after the death of the remaining parent, if the latter does not waive his or her right to inherit. Children of the first deceased spouse, that are not children of the surviving spouse, have, however, priority. They inherit their share from their biological parent, thus partially excluding the right to the inheritance for the surviving spouse (step parent).

The first deceased spouse can make a will totally disinheriting the surviving spouse. For small estates there is, however, one exception, which is of no importance for this paper. The first deceased spouse cannot make a will totally disinheriting the descendants. A child can always claim his or her lawful portion, which is half of what the child would have inherited without the will.

There is no inheritance tax on the surviving spouse's share of the matrimonial property. The remaining property (the estate of the deceased spouse) is in most cases fictitiously distributed by a court according to the Inheritance Act and the inheritance tax is calculated on each share. A basic amount can be inherited without tax. In 2001, it was for a surviving spouse 280,000 SKr (around 31,000 Euro) and for a descendant 70,000 SKr (approximately 7,800 Euro).

The property in an estate is valued according to certain rules in the Inheritance Taxation Act. Shares in small and medium-sized family-owned and unlisted companies are mostly valued in accordance with a certain method ("substance value method"), aiming to reach a market value, and the result is reduced to 30%. This is done in order to facilitate succession of these firms.

Insurance policies that are owned by the entrepreneur and paid out in a lump sum upon his or her death are regarded as an inheritance. A relatively high amount can be inherited without taxation.

Example: The man X is married to Y. They have one child; a son A. X also has a daughter P from a previous relationship. X is an entrepreneur and sole owner of a company with a "substance value" of 12 million SKr (around 1.3 million Euro). The total matrimonial property has an estimated value of 4 million SKr. When X dies the first step is to divide the matrimonial property, including the company. Y's share amounts to $(12 + 4) \div 2 = 8$ million SKr. The other half becomes the value of the estate of the deceased X, which will be the subject of inheritance. If Y wishes to have her whole share and if she first takes the total matrimonial property, she will have a claim on shares in the company up to a value of $(8 - 4 =)$ 4 million SKr. If A wants to continue the business as the only owner he will have to compensate Y with money. Further, P has a right to inherit from X before Y. P's share amounts to $(8 \div 2 =)$ 4 million SKr. To buy her out will be costly for A. All together he will have to pay $(4 + 4 =)$ 8 million SKr, if B waives her right of inheritance $(8 - 4 =)$ 4 MSkr. A's only reasonable chance (if any) to take over the company is thus to convince Y to waive her right to inherit from

X. If she does, A will have to pay 1,089,000 Skr in inheritance tax.

5. The Swedish inheritance and tax laws and efficient succession

If no transition of the family company has been made during the lifetime of the owner the legal system can certainly make it difficult to find a settlement between the parties that preserves idiosyncratic knowledge and thereby also promotes the value of the family business. We will give a couple of examples.

The civil law rules concerning division of the matrimonial property and inheritance give rise to disputes, e.g. over ownership of shares in the family company. All property is distributed to the surviving spouse, if the deceased spouse had made no will and is not survived by children from another relationship. Offspring have to wait for their inheritance, e.g. shares in the family company, if the surviving spouse is not willing to waive, totally or partially, the inheritance. Children who wish to gain ownership to shares in the firm, are thereby given incentives to try to get shares through gifts, a will or in other ways during both their parents' lifetime, as shown in the example above. Such a rent seeking-behaviour will not promote the for business positive impact of informal rules (Section 3.2).[31] The inheritance tax system has further influence.

According to the main rule the surviving spouse is, as mentioned above, inheritance-taxed on half of the property, the estate of the deceased spouse, if the surviving spouse does not waive the right to inherit. Tax has to be paid on the value exceeding the basic amount (280,000 SKr in year 2001). When the surviving spouse dies, half of the estate will be distributed to the children as an inheritance from the first deceased spouse. The remaining part is inherited from the surviving spouse. Inheritance tax has to be paid in both cases. The half that is considered as an inheritance from the first deceased spouse is thus (at least partially) taxed twice ("double taxation") before the next generation as owners can make use of the property. This gives the children further incentives, through rent-seeking behaviour, to make efforts to gain ownership to shares during the lifetime of their parents.

If the first deceased spouse leaves a child from an earlier relationship, that child will inherit its share of the former's estate, including the value of the share in the family business, before the surviving spouse. Once the child has inherited from the first deceased spouse it will not have a right to further inheritance when the surviving spouse dies. The system thus gives children, who wish to gain ownership to shares in the firm, further reasons to act during the lifetime of their parents, in order to avoid that the child from an earlier relationship gains advantages through its right to inherit before a surviving spouse. Again, some kind of rent-seeking behaviour is to be expected.

The above-mentioned complexities give an entrepreneur, who is aware of all these rules, reasons to carry through the succession of the family firm during his or her lifetime. This will, however, give rise to other difficulties, when it concerns legal dispositions, which have already been alluded to above. Gifts of shares in the family company will give rise to gift tax and sale of shares can be costly due to the capital gains tax. The different alternative legal dispositions, in a transition during the lifetime of the owner, are dealt with in another paper (Bjuggren and Sund, 2000).

6. Summary and concluding remarks

The low frequency of intergenerational successions within the family during the lifetime of the entrepreneur is a problem, not merely for entrepreneurial families, their businesses and the local communities but for a society in general. When a succession fails and a business goes bankrupt or is sold to a third party, the special competitive advantages of a family business are lost. These advantages are idiosyncrasies of different kinds. There is an idiosyncratic knowledge of how to make the family firm profitable; an inherited knowledge that is acquired in a learning by watching and doing fashion. There is also a competitive advantage of being part of a transaction cost reducing social network. Family ties serve as an entrance ticket to such social networks.

Of course, as shown in several studies, in some families the children are simply not interested in taking over their parents' business. Children sometimes prefer to be employed or start their own businesses. In other families there might be no one suitable to carry on the business in the next generation. In these cases the family business should be sold to outsiders.

Since most intergenerational successions do not seem to be initiated, planned and carried through during the life time of the entrepreneur (Section 2), it is urgent to adapt the rules of inheritance and inheritance taxation of a country to the special problems facing a family where the founder or entrepreneur dies intestate and was the majority owner of the family firm.

The complexity of an institutional framework such as the Swedish intestate rules increases the risk that an intergenerational transition that has not been carried through during the lifetime of the entrepreneur and who dies intestate, fails and the company goes bankrupt or has to be sold to an outsider. Valuable knowledge about how to run the business will in many instances be lost.

The main rule that the surviving spouse inherits all estate is an example of an intestate rule that is likely to cause transitional problems. If a surviving spouse inherits the shares in the family firm and if he or she has been active in running the business the important idiosyncratic knowledge will be preserved for some additional time. However, if the surviving spouse has not taken part in the business the problems will immediately arise. Given the above-mentioned advantages with transitions within the family and given that the children born into the relationship have an interest to take over the business, they will have incentives to start a rent seeking-behaviour or to set up their own businesses. This will strongly hamper the possibilities for their idiosyncratic knowledge and the informal rules to improve the value of the family firm. In our opinion, a surviving spouse should only inherit the deceased spouse's share of the joint dwelling, or at least, not the shares in a family business. If the spouses wish the surviving spouse to inherit the shares they can always make a will to this end.

If for political reasons, or otherwise, it is not considered appropriate to limit the right of a surviving spouse to intestate succession, at least the above mentioned "double taxation" (on inheritance – Section 5) should be abolished.

Furthermore, in the tax system, there should be rules – in accordance with the EU-recommendation – to ensure that the tax assessment of the business takes account of decreases in the value of the family firm that might take place some months after the death of the majority owner. Also the tax rate should be considerably lowered and the heirs should be offered a possibility of spreading or deferring payment of inheritance taxes.

Acknowledgements

We have benefitted from helpful comments from Dr. Roland Kirstein and participants at the 15th Annual Conference of EALE in Utrecht, on 24–26 September 1998 and discussant and participants at the international workshop in Jönköping.

Notes

[1] The European Observatory for Small and Medium-Sized Enterprises, 2000, pp. 11–13 and 44–46.

[2] European Commission, Communication, 1994, July 23, p. 1.

[3] The European Observatory for Small and Medium-Sized Enterprises, 1996, p. 186.

[4] Stoy Hayward, 1989. For references to other studies confirming the result, see Handler, 1994, pp. 147–148.

[5] Greenwald, 1993.

[6] Schulze and Dino, 1996, pp. 187–207.

[7] Kirby and Lee, 1996, pp. 75–85. For further examples, see references in The European Observatory for Small and Medium-Sized Enterprises, 1996, pp. 184–185.

[8] The European Observatory for Small and Medium-Sized Enterprises, 1996, pp. 184–185.

[9] See further in The European Observatory for Small and Medium-Sized Enterprises, 1996, pp. 188–189.

[10] European Commission, 1994, December 31.

[11] See Davis and North, 1971 and North, 1990.

[12] Williamson (1975) lists different human and environmental factors that are decisive in choice of transactional mode. The bounded rationality of the human being and the complexity/uncertainty of the environment are two primary sources of transactional problems in contractual relations. Because of bounded rationality complexity/uncertainty is important in analysis of transaction costs. Williamson pays special attention to the case where bounded rationality is paired with bilateral dependency (lack of competition). (Knowledge idiosyncrasy of the type here described is one reason for bilateral dependency.) Uncertainty/complexity and bounded rationality give rise to situations with asymmetrical distribution of information about exchange conditions. Bilateral dependency invites in such situations to opportunistic behaviour in arm's length transactions and makes them costly. Succession of a family firm to heirs is not an arm's length transaction. The family ties are likely to weaken the incentives for opportunistic behaviour.

[13] See Polanyi, 1962.

[14] The remarks made by Marshall (1920) in his discussion of localised industries are apposite. Marshall writes: "When an industry has thus chosen a locality for itself, it is likely to stay there long: so great are the advantages with people following the same skilled trade get from near neighbourhood to one another. The mysteries of the trade become no mysteries; but are as it were in the air, and children learn many of them unconsciously." (Book IV, Ch. X, § 3).

[15] The trustworthiness of sons and daughters is a reflection of the advantages of family governance of activities compared to other forms of governance. According to Pollak (1985) these advantages "can be grouped into the four categories: incentives, monitoring, altruism, and loyalty." Incentives for behaving trustworthily are fostered by consideration of both the family honour and concern for coming generations. The intertwining of economic and personal relationships facilitate monitoring. Altruism makes the family members less opportunistic vis à vis each other. Furthermore, a sense of loyalty for the other family members makes family reputation very important and thereby curbs opportunism (see following section).

[16] Morck et al. (1989) show that a founding family in top management is, other things equal, less exposed to control from the board and outsiders than other management teams. This indicates that the agency problems might be more severe than if the founding family stays on as salaried managers.

[17] Ackerlof, 1970.

[18] The concepts institutional environment and institutional framework are used as synonyms.

[19] A first definition is offered in Davis and North, 1971, pp. 6–7.

[20] A comparison can be made with Williamson's concept atmosphere which "is intended to make allowance for a ttitudinal interactions and the systems consequences that are associated therewith" (Williamson, 1975, p. 37). Williamson depicts graphical atmosphere as a circle within which transactions are embedded. It does not seem too far-fetched to replace atmosphere with the concept institutional framework.

[21] Gnosjö, a small municipality in the South of Sweden, and the Third Italy, made up of seven regions in the Centre and Northeast of Italy, have received a lot of attention in the economic literature for ability to generate high growth, low unemployment figures, entrepreneurship and having an industrial structure characterised by many small family-owned firms. The Gnosjö region and its industry is described in inter alia Karlsson and Wiklund, 1994, Eriksson and Falkäng, 1997 and Johannisson, 1984. Among the many books and articles writing about the Third Italy can be mentioned Goodman, 1989, Becattini, 1990, Garofoli, 1991 and Rabellotti, 1997.

[22] North, 1990, p. 36.

[23] North, 1990, p. 42 writes, "culture defines the way individuals process and utilise information and hence may affect the way informal constraints get specified".

[24] By having an indefinite time span a supergame situation arises. In such a game there is according to the folk theorem a large number of equilibrium outcomes resulting in cooperation (see e.g. Kreps, 1990, Ch. 14).

[25] See e.g. Johannisson, 1984; Goodman, 1989; and Rabellotti, 1997.

[26] See e.g. Johannisson et al., 1994; and Rabellotti, 1997.

[27] E.g. Karlsson and Klaesson ,1998 find that the industries in the Gnosjö region, a Swedish industrial district, have a higher profitability than for the average regions.

[28] In the industrial district Gnosjö there are for example no firms with more than 500 employees and very few with more than 200 employees (Karlsson and Wiklund, 1994).

[29] In manufacturing industry the Gnosjö region shows the highest number of new firms per thousand inhabitants (Davidsson et al., 1996, p. 75).

[30] Johannisson (1984, p. 40) reports in a comparison regions in the South of Sweden that a much higher proportion of the businessmen in Gnosjö and Skillingaryd are brought up locally than in the other regions studied.

[31] See Buchanan (1983) and Sisk (1985) about rent seeking in connection with inheritance.

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