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AN INTERNATIONAL STUDY OF THE IMPACT OF CULTURAL FACTORS ON THE PREVALENCE OF FAMILY-OWNED FIRMS

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FACTORS ON THE PREVALENCE OF FAMILY-OWNED FIRMS

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Abstract

A key question in international corporate governance is why certain in ownership types are prevalent in different countries around the world (La Prota *et al.*, 1999). In this study, we provide an answer for the prevalence of the family-owned firms in 42 countries by examining key characteristics of culture. We show that family-ownership is positively correlated with power distance (PD), in-group collectivism (CI) and, insignificantly, with uncertainty avoidance (UA). Our study makes a contribution to the field since previous research used religion and language as umbrella constructs for culture, while we pinpoint specific cultural dimensions.

Key words: family-owned firms, cultural differences, ownership type, international study

1. Introduction

A crucial component of corporate governance is ownership structure. Among the possible configurations, including ownership by state, family, individuals, financial institutions such as banks, and the widely-held corporation, the family-owned firm is of special interest. The main research question of this study is whether cultural differences impact the prevalence of family-owned firms.

This research question is important for two reasons. First, family-controlled firms are not subject to the principal-agent relationship between shareholders and management, that characterizes widely-held, management-controlled firms (see e.g., La Porta *et al.*, 2000; Lins, 2003; Maury, 2005; Mueller, 2006). Rather, minor shareholders are concerned that their share in the firm will not be expropriated by the major shareholders (Shleifer and Vishny, 1997; La Porta *et al.*, 2000, Schulze *et al.*, 2001; Stultz, 2005). Expropriation can take a variety of forms. In some instances, the controlling owners simply divert the profits. For example, Sir Conrad Black awarded himself millions dollars of "no competition fees" without the knowledge of his board of directors. In other instances, the insiders sell output, assets or additional securities in the firm they control to another firm in their control or take loans that benefits a business they control. Adelphia, the once seventh largest cable company in the United States, is an example of this technique. The controlling Rigas family borrowed hundreds of millions of dollars in the name of Adelphia to finance other business ventures and the debt contract specified that Adelphia is responsible for the debt even if it does not enjoy any benefit from it. Other forms of expropriation is to divert corporate opportunities from the firm, as Scrushy, who founded, managed as a CEO, and chaired the board of directors of HealthSouth, established a real estate enterprise that sold properties to HealthSouth. In other instances, expropriation involves

installing possibly unqualified family members in managerial positions (see Bukhart *et al.*, 2003 and the citations therein) or overpaying executives and giving them excessive perks (Chen *et al.*, 2009).

Second, family-owned firms are quite prevalent all over the world and, with a few exceptions (Faccio and Lang 2002), families in family-owned firms augment their control rights beyond the level of their cash flows rights. They supplement their control by designing pyramid holdings, having dual-class shares, taking over the actual management of the firm (Babchuk *et al.*, 2000; La Porta *et al.*, 1999a; Anderson and Reeb, 2003; Morck *et al.*, 2003, Joh, 2003; Lins, 2003; Villalonga and Amit, 2006; Masulis *et al.*, 2009) and controlling the board (Anderson and Reeb, 2004). Studies that calculate the voting control of corporations internationally found that family-controlled firms remain more prevalent than the wide-spread firms envisioned by Berle and Means (1932). La Porta *et al.* (1999a) reported that in their 1995 sample of the twenty largest firms (as measured by market capitalization) in 27 developed countries, 30% are controlled by a family (where control is measured by having at least 10% of control rights) and that this percentage is much higher for smaller firms. Claessens *et al.*, (2000), who studied 2,980 publicly-traded companies in nine East Asian economies (Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, Taiwan and Thailand) found that more than half of the east Asian corporations are controlled by families. Lins (2003) studied the control structure in 1,433 firms in 18 emerging market using data set from 1995 and reported that managers and their families are the largest blockholder in two-thirds of his sample firms.

Furthermore, family ownership is sometimes concentrated in the hands of a few families. Claessens *et al.* (2000) reported that in each country in their sample, the ultimate control of the corporate sector rests in the hands of a small number of families. At the extreme, the Suharto and

the Ayala families ultimately control 16.6% and 17.1% of total market capitalization in Indonesia and the Philippines, respectively. The largest ten families in Indonesia, the Philippines, and Thailand control half of the corporate sector (in terms of market capitalization), while the largest ten families in Hong Kong and Korea control about one-third of the corporate sector. Even in the United States, which would seem to fit Bearle and Means' model of firms that are widely-owned and management-controlled, Anderson and Reeb (2003) found that one-third of the S&P 500, the largest US firms, are managed or controlled by a founding family who owns on the average 11% of cash flows rights and 18% voting rights. Family members serve as top executives or CEO in 63% of the companies and on the board as directors or as chairperson in 99%. Faccio and Lang (2002) analyzed the ultimate ownership and control of 5,232 corporations in 13 western European countries found that over 44% are family controlled.

The observation that "[v]irtually all firms start out as family firms" (Mueller, 2006, p. 638), implies that the issue of what drives the variation in the prevalence of family-controlled firm becomes an important question. [This question is a variation on the one asked by La Porta *et al.*, (1999a, p. 473), "What explains the differences in countries in their ownership patterns? "]

The early attempts to answer this question examined the differences between legal regimes and focused on the legal protection of shareholders, because of the aforementioned concern of minor shareholders that the major shareholder will expropriate them (e.g., La Porta *et al.*, 1999a; 2000, 2002; Burkart *et al.*, 2003, Denis and McConnell, 2003; Lemmon and Lins, 2003; Luez *et al.*, 2003; Ho *et al.*, 2004; De Holan and Sanz. 2006). The evidence suggests that family-controlled firms are indeed more prevalent in countries with poor legal protection of minor shareholders.

Considering that better protection strengthens capital market development and economic growth (see e.g., Dyck and Zingales, 2003), the focus on legal protection does not provide a satisfactory answer, because governments have both the incentives and the ability to take actions that improve the protection of investors.

At this crossroads, the research divided into two strands. One examines governance at the firm level because, at that level, firms might achieve what a national legal system cannot, by tailoring their governance structure to investors' preferences (e.g., Klapper and Love, 2004; De Holan and Sanz, 2006; Ali et al., 2007). While on the average, countries with better shareholder protection also have better governed firms, on the level of individual firms, there is no national pattern. Klapper and Love (2004), for example, studied 495 firms in 18 sectors in 25 emerging markets and found that there is a wide variation in firm-level governance that is unrelated to the legal environment. There are well-governed firms in countries with a weak legal system and badly governed firms in countries with strong legal system.

Another approach was to trace legal protection to the country's history (La Prota et al., 2000), to cultural differences that defined as a system of beliefs that shape the actions of individuals within a society, as manifested in religion and language (Stultz and Williamson, 2003) and the degree of tax compliance (Ho et al., 2004). Religion was selected as a factor because the Roman Catholic Church is thought to foster power distance (defined below), which Putnam (1993) labeled "vertical bonds of authority" as opposed to "horizontal bonds of fellowship." Landes (1998) argues that Catholic and Muslim countries tend to be hostile towards institutional development because they develop xenophobic cultures and powerful bonds between church and state to maintain control, bonds which limit competition and private property rights protection. Religion, however, is an umbrella concept of cultural differences, and

it seems that there is room to break culture into specific indicators in order to pinpoint specific factors that drive the prevalence of the family-owned firm.

In this study, we examined three specific indicators of culture that may explain the emergence of a family-controlled firm: power distance (PD), in-group collectivism (CI) and uncertainty avoidance (UA).

Power Distance is the degree to which people respect power and authority. As an expression of the legitimacy accorded to status differences among social groups, PD can be expected to be of special relevance to a family's share in the firm's equity. In countries where PD is large, the owners of the family-owned firms are more likely to command respect and be effective leaders, which guarantees of the success and viability of the family-owned firm. CI measures attitude towards individualism versus feeling of belonging to a group or the family. The higher this measure, the higher the importance of family in the society, which enhances the prestige of the family-owned firm. Finally, uncertainty avoidance measures tolerance for ambiguity and uncertainty. The higher UA, the lower the need to lean on the family when one initiates a risky businesses.

We find that the first two variables explain the likelihood of high concentration of family-owner firms in our 42-country sample, but unlike Buck and Shahrim (2005) who also use UA to explain the emergence of family-controlled firms rather than widely-held firms, we find that this attribute is insignificant. Specifically, power distance increases the chance that the average country in our sample will have an above-average concentration of family-owned firms by 95% and in-group collectivism by 99%.

Our contribution to the literature on governance is twofold. While there is literature establishing that cultural dimensions affect certain elements of firm governance such as

accounting, information disclosure, self-dealing, insider trading, and executive pay (Licht, 2001,

Mintz, 2005. See also the survey in Buck and Shahrim, 2005), we know of no prior research

studying the impact of cultural differences on the prevalence of family-owned firm as an

ownership type. In doing so, we deepen our understanding of why different countries have

different concentration of family-owned firms beyond the prior literature finding of the link

between culture, language, and tax compliance to this type of ownership as discussed above.

The paper proceeds as follows: In Section 2, we present the hypotheses and the theory behind

the control variables. Sections 3 and 4 present the methodology and results, respectively, and

Section 5, summarizes.

2. Hypotheses and Control Variables

2.1. Hypotheses

As discussed in the Introduction, our contribution to the international literature on the

likelihood of family-owned firms focuses on country-specific cultural dimensions. We

hypothesize that PD, UA, and CI will be the premier cultural dimensions for explaining the

differences in the weight of family shareholders in goods and services markets between

countries. The use of separate dimensions in lieu of a composite measure follows Shenkar's

(2001) criticism that Kogut and Singh's (1988) study of cultural distance made "an invalid

assumption of equivalence."

Power distance (PD) is the degree to which people expect power and authority to be

distributed and expressed equitably or inequitably (Hofstede, 1980, 1983; Carl *et al.*, 2004). The

term was coined by Mulder (1977) regarding the degree of inequality in power between a less

powerful individual and a more powerful individual, when both belong to the same social

system. Higher levels of power distance are consistent with higher regard towards authoritative figures such as father figures. Therefore, it can be expected that PD will be of special relevance to family weight in equity because it is an expression of the legitimacy accorded to status differences among social groups. The implication of power distance at the firm level is that power distance reflects the level of comfort within certain control levels: for instance, employees in low power distance cultures tend to favor consultative management styles, while those in high power distance cultures typically opt for an authoritarian or paternalistic style (Hofstede, 1980, 1997; House *et al.*, 2004). In the GLOBE project, "power distance" was defined as "the degree to which members of an organization or society expect and agree that power should be shared unequally" (House *et al.*, 2004, p. 517). We hypothesize that

H1: High levels of power distance in the country's culture will be positively related to an increased weight of family shareholders.

Individualism/Collectivism (CI) measures the extent to which the self or, alternatively, the group, is the prime social identifier (Hofstede, 1997). The GLOBE research distinguishes between "institutionalism collectivism" and "in-group collectivism," the former focusing on the societal and organizational levels while the latter focuses on the individual level (House and Javidan, 2004). In-group collectivism is defined as "the degree to which individuals express pride, loyalty and cohesiveness in their organizations or families" (House and Javidan, 2004, p. 12 [emphasis added]). Individualist cultures emphasize personal achievement, personal accountability and performance based-evaluation; people consider themselves independent and autonomous. In contrast, in collectivistic cultures the emphasis shifts to group coordination and to stable group membership (Hofstede, 1997), combined with group decision-making (Gelfand *et al.*, 2004). Since the viability of a family-controlled firm depends on its profitability, which

requires the cooperation of its constituency, and because a higher percentage of business activity in collective-oriented cultures takes place between friends and family, we hypothesize that:

H2: High levels of individualism in the country culture will be positively related to higher weight of family shareholders.

Uncertainty Avoidance (UA) assesses the degree to which a society's members are able to cope with the unpredictability of the future and the resulting ambiguity (Hofstede, 1980). UA was defined in GLOBE in terms of structured lifestyles, clear specification of social expectations, and rules and laws to regulate uncertain situations. Cultures with high uncertainty avoidance tend to favor certainty. Several previous studies claim that the UA dimension influences corporate governance. Following Licht *et al.* (2004), who links UA to certain characteristics of governance, Buck and Shahrim (2005) use UA to explain the emergence of family-controlled firm instead of the widely-held firm. High UA will create a "family-based capitalism." A plausible explanation is that high UA encourages entrepreneurs to lean on family members more. As a result, different types of corporate governance evolves in different countries. We hypothesize that:

H3: High levels of uncertainty avoidance in the home country culture will be positively related to higher weight of family shareholders.

2.2. Control Variables

To improve the analysis, we considered seveal control variables that the literature has already established as relevant to our research: information and disclosure, the banking system, and development of capital market.

2.2.1. Share of banking sector in private hands

Diamond (1991) and Tirole (2001) observed the importance of *reputational capital* in the relationship between lender and borrower, meaning that lenders also consider the borrower's "character" and "track record." Consequently, if family-owned firm is considered more diversified because of its pyramidal holdings and has acquired a stronger record, it will be more likely that family-owned firms will not suffer from liquidity problems and be able to prosper and survive the larger the share of banking sector in private hands.

2.2.2. Information and disclosure

As La Porta *et al.* (2000) observed, expropriation activity creates "private benefit of control" for the controlling shareholders. However, attaining this private benefit requires secrecy. Ali *et al.* (2007) found, for example, that family-controlled S&P 500 firms disclose less information about their governance practice, although their reporting and disclosure strategy is better in other dimensions, such as bad-news warnings and the quality of accounting information. Since the market rewards disclosure and transparency (Durnev and Kim, 2005; La Porta *et al.*, 2002), increased disclosure makes family-owned firms more appealing to the shareholders and lend higher credibility to its reports (Fan and Wong, 2002), because makes it more difficult to acquire the private benefit of control.

As a side comment, we observe that some studies find that countries with stronger investor protection have a higher quality of earnings and disclosures (Lutz *et al.*, 2003, Haw *et al.*, 2004, Francis *et al.*, 2003), which implies a negative association between the incidence of family-owned firms and disclosure because these firms are more prevalent in the weak-protection countries. This conclusion may be the outcome of a spurious correlation and will not be further pursued here, especially since Ali *et al.* (2007) and Jiraporn and DaDalt (2007) for a US sample,

and Jaggi *et al.*, (2009) for Hong Kong sample, found a negative association between family-owned firms and earnings management. [An exception is Atmaja *et al.* (2008) for Australia.]

2.2.3. Openness of bank capital to foreign shareholdings

In principle, when loans are sufficiently large, the terms of the loan are based on negotiations between the lender (the bank) and the borrower (the family-controlled firm). As discussed in the Introduction, the managers of family-controlled firms are likely to manage additional businesses through pyramidal holdings. Hence, they are likely to have bargaining power that contributes to the success of family-owned firms. Bargaining power, however, depends on the alternative investment opportunities available to the lender. Hence, we expect that the relationship between the openness of bank capital to foreign shareholdings and the incidence of family-owned firms, and the relationship between foreign-owned or partly-foreign-owned firms' access to loans from local banks and the incidence of family-owned firms to be both negative.

2.2.4. Access of local firms to international financial markets

Masulis *et al.* (2009) found that access to outside funding is crucial to the prevalence of family-owned business groups. As a matter of fact, this variable is more important to the survival of the family-owned firm than the strength of the corporate governance environment. Hence, the association between the presence of family-owned firms and this variable is expected to be positive.

3. Methodology

3.1. Sample

To examine our hypotheses we used two major data sources:

3.1.1. National Culture, Organizational Culture, and Leadership Survey (GLOBE)

In this paper, national culture was primarily estimated using variables from the House *et al.* (2004) GLOBE study of 62 societies. There is an ongoing debate concerning the merits of different measures of national culture (for recent examples see Earley, 2006; Hofstede, 2002, 2003, 2006; Javidan *et al.,* 2006; Sivakumar and Nakata, 2001; Spector and Cooper, 2002; Spector *et al.*, 2001) but the GLOBE study is "probably the most sophisticated project undertaken in international business research" (Leung, 2006, pp. 881). The GLOBE research program is a long-term, multiphase research program that uses several methods and includes nine culture dimensions. All the respondents were middle managers. By administrating the questionnaires to separate samples in same organization or society, they minimized, or possibly eliminated, common source response biases concerning societal and organizational phenomena.

The GLOBE sample included countries from North and South America, Asia, Europe, the Middle East, and the Pacific Rim. A total of 17,370 middle managers from 951 domestic organizations (excluding multinationals) in three industries completed questionnaires on culture and leadership. The number of respondents by countries ranged from 27 to 1,790 with an average of 251 respondents per country. The profile of the respondents was mainly males (74.8%) with an average of 19.2 years full-time work experience, of which an average of 10.5 years was as managers. They reported that having worked for their current organizations an average of 12.2 years.

3.1.2. The 2006 Institutional Profiles Database

This database is a set of indicators on the institutional characteristics of 85 developed and developing countries that represent 90% of the planet's population and GDP. Its scope covers a broad spectrum of institutional characteristics including corporate governance, openness of

society and markets. As explained by Meisel and Aoudia (2007), the database was built by researchers working at the French Ministry for the Economy, Industry and Employment and the French Development Agency based on a survey conducted by their agencies in the countries covered. Common subjects were then correlated with the leading, existing indicators (Transparency International's corruption perception indicator and indicators used by Reporters without Borders and Freedom House, etc.). The results were compared with the views of knowledgeable experts on the relevant countries and amended accordingly.

To examine our hypotheses, we used data from 42 countries included in both the GLOBE and the Institutional Profiles Database surveys. See Table 1 for the list of the countries:

Table 1: Countries In Both Databases

Argentina	Kazakhstan
Bolivia	South Korea
Brazil	Kuwait
Canada	Morocco
China	Mexico
Columbia	Malaysia
Egypt	Nigeria
Spain	New Zealand
France	Pakistan
Great Britain	Philippines
Greece	Poland
Guatemala	Portugal
Hong Kong	Russia
Hungry	Singapore
Indonesia	Sweden
India	Taiwan
Ireland	Thailand
Iran	Turkey
Israel	USA
Italy	Venezuela
Japan	Zimbabwe

3.2. Variables

3.2.1. Dependent variable

The 2006 Institutional Profiles Database identifies the weight of family shareholders in goods and services markets (i.e., excluding the banking sector) in the 42 countries listed above.

3.2.2. Independent variables

We employ two groups of independent variables. The first group consists of three cultural variables from the GLOBE data: power distance (PD), in-group collectivism (CI) and uncertainty avoidance (UA). See Section 2 for the logic behind using these variables as the independent variables for explaining the weight of family shareholders. The second group includes the local financial market environment as captured by the Institutional Profiles Database. See Table 2 for the list of the variables we used in our regression as discussed in Section 2.

Table 2: Logit Regression, Dependent Variable: Weight of Family Shareholders

Variables	Coefficient
Constant	-48.63*
PD	0.57*
CI	2.77*
UA	-0.89
Share of banking sector in private hands	1.26$^+$
Compulsory publication of information by firms at the time of share issues	1.16$^+$
Openness of bank capital to foreign shareholdings	-1.68*
Access of foreign-owned or partly-foreign-owned firms to loans from local banks	-0.88$^+$
Access of local firms to international financial markets	1.31*
Classification Table	78.6%
P value of the regression	0.048
+ $p < 0.10$ * $p < 0.05$	

3.3. Analytical Method

We used logistical regression to test our hypotheses. The dependent variable in this study (weight of family shareholders) is a binary, independent variable, denoted as 1 when the country has a weight higher than the average of the 42 countries in the sample or 0 when it is lower than the average. We did not use an OLS regression because the dependent variable does not distribute normally and the sample is a small (n=42). This led to concern that the errors would not be normally distributed.

4. Results

The primary logistical regressions that result from our analysis are shown in Table 2. As pointed out by Menard (2002), logistical regression lacks widely-accepted measures equivalent to an R-square

To sharpen our contribution, note that because the logit regression treats the dependent variable as a binary one, who is either one or zero, a positive coefficient on a dependent variable indicates a higher probability the dependent variable being one – the concentration of family-owned firms is above average-- and a negative coefficient means a higher probability of zero– the concentration of family-owned firms is below average .

Equation 1 shows how the coefficients indicate the probability of having 1:

$$P_i = \frac{\exp^{xb}}{\exp^{xb} + 1} = \frac{1}{1 + \exp^{-xb}} \ . \tag{1}$$

where P = the probability of having 1.

x = the vector of the variables of the logit regression

b = the vector of the coefficients of the variables in the logit regression.

To illustrate the support that our regression provides for our hypotheses, we use Equation (1) to calculate the marginal impact the independent variables has on the probability of having 1. Consider, for instance, the power distance (PD). Substituting the coefficients (0.57) of the respective logit results (Table 2) for PD yields:

$$P = \frac{1}{1 + \exp^{-0.57*PD}}. \tag{2}$$

The results of Equation 2 are displayed in Figure 1. The Y axis depicts the marginal effect on the probability moving from 0 to 1; and the X axis are the values for power distance which range from zero to seven. For example, when PD = 0, the probability of family-owned measure. Instead, we include the classification table figure as an indication of firm is 0.50 when PD increases to 1, the probability rises to just short of 0.64. goodness of fit (which considered acceptable when above 50%). As evident in Table 2, the regression was significant with a p-value of 0.048. Hypotheses 1 and 2, regarding the positive impact of the PD and UI culture dimensions, are supported in the regression. Hypothesis 3 is not supported by the analysis. All control variables have the expected sign and are significant

FIGURE 1: POWER DISTANCE AND ITS EFFECT ON THE PROBABILITY OF FAMILY -OWNED FIRM
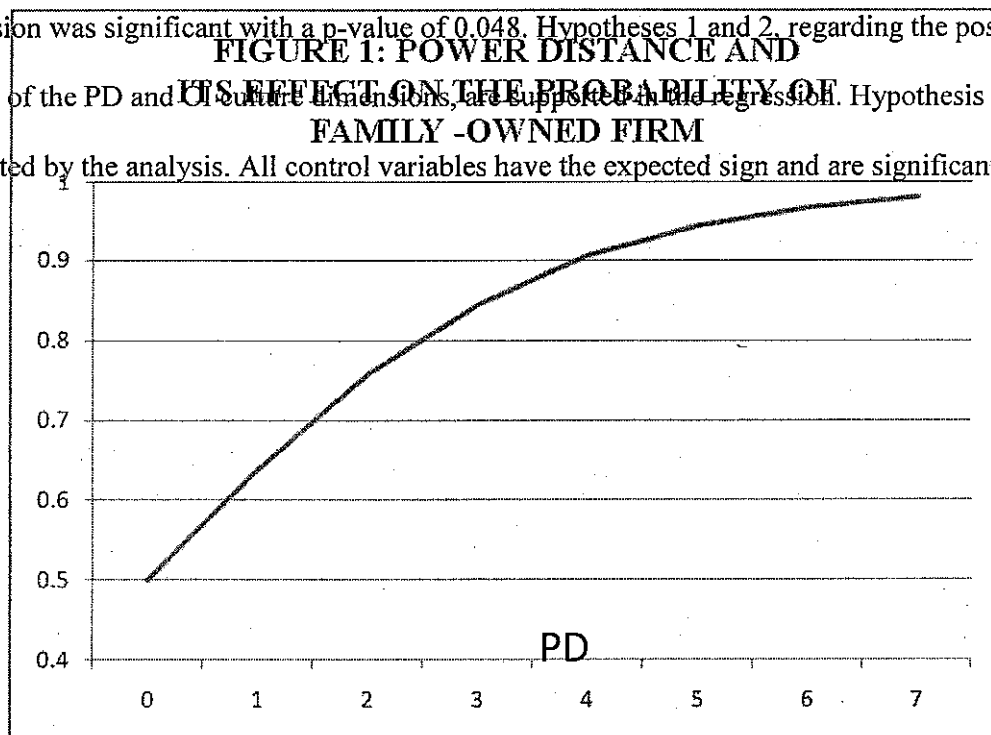
In Greece, for example, the marginal impact of PD on the probability of having above average concentration is 0.83.

5. Summary and Conclusions

In this study, we provide a clear answer to the research question whether cultural differences impact the prevalence of family-owned firms. By examining 42 countries, we discovered that the pervasiveness of family-owned firms is indeed influenced by the local culture. In our empirical test, we used three cultural variables: power distance, in-group collectivism, and intolerance to uncertainty. In a country with high power distance and high in-group collectivism, a patriarch, and through him, his family, are respected, obeyed and enjoy the cooperation of the firm's constituency, which increases the effectiveness of the family-owned firm and, hence, its prosperity. In a country with low tolerance for uncertainty, there is demand for assurance provided by having family members as partners. We find that the first two variables explain the differential prevalence of family-owned firms significantly better than the economic variables that determine the ease with which a family-owned firm can raise outside capital, including mandatory disclosure requirement. In conclusion, this study augments our knowledge about the importance of cultural differences for family ownership by studying specific cultural dimensions beyond religion, language, and legal environment studied previously.

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