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Keeping it in the family

Exploring how the context-dependent effects of family business succession on inequality of opportunity can contribute to policy

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Is the practice of inheritance legitimate? This was the question posed to philosophers, economists, and other social scientists in a conference subtitled "Ethical and Economic Aspects of Wealth Transfers" at the University of Antwerp in 1995. Haslett (1997), in a contribution to the conference entitled "Distributive Justice and Inheritance", argued that the practice of inheritance is illegitimate. The practice of bequeathing wealth, he claimed, is inconsistent with an essential value of capitalism: equality of opportunity. Inherited wealth gives an individual access to certain opportunities (e.g. personal investment in productive capital) that others cannot have without such wealth. In a similar vein, Halliday (2018) argues that the practice of inheritance results in economic segregation, which occurs when "an individual's life prospects, and/or social status, depend on [whether] his or her group […] [possesses] greater wealth than other groups" (1). He further explains, "[the practice of inheritance makes] one's prospects in life become dependent on the fortune of being born into a family that already possesses substantial wealth, which it has managed to retain through the passing of generations" (1).

Family business succession is a specific type of inheritance that has received little attention in the literature, but retains these potentially negative impacts on equality of opportunity. There are two ways in which a family business can be inherited: by passing on ownership of the business, or by passing on management of the business. Business ownership succession, on the one hand, involves a kind of wealth transfer wherein the wealth grows as the business itself grows, even without the inheriting person's active effort. This gives individuals inheriting ownership of a business an unfair advantage over others whose parents do not possess such productive capital, much less pass it down to their children. Business management succession, on the other hand, might involve giving family members an advantage over equally qualified (or even better qualified) non-members of the family when making appointments for vacant positions left by retired or deceased family members.

While family businesses may no longer be the norm in the developed world, they are still very much a widespread phenomenon in developing economies. In 2013, in the Middle East and Eastern Europe, at least 60% of large companies are family-owned (Björnberg, Elstrodt, and Pandit 2014). This percentage goes up to at least 70% in India and Latin America, and at least 80% in Southeast Asia. As family business succession is very much relevant in large parts of the developing world today, and due to its potential negative impacts on equality of opportunity, it is valuable to bring the ethical and economic discussion on the practice of inheritance and equality of opportunity into the realm of family business succession. In order to do so, I will concentrate specifically on two research questions.

The first research question that I address in this essay is the following: Does family business succession have a negative impact on equality of opportunity? I argue that this answer depends on certain background conditions in place in society. Whether business ownership succession negatively affects equality of opportunity hinges on whether the family that owns and manages the business is coming from an overall position of disadvantage or privilege. Whether business management succession negatively affects equality of opportunity depends on whether the company is in a competitive industry that would be able to punish inefficient nepotistic behavior.

The answer to the first question then informs the answer to the second research question of this essay: Should business ownership and management succession be prohibited or controlled? Specifically, I argue that policies that aim to control business ownership succession in order to promote equality of opportunity should primarily target large family-owned firms, defined as corporations listed on an exchange, rather than small family-owned firms, defined as sole proprietorships or partnerships that are unlisted. Families that own large businesses have access to more opportunities to increase their wealth than families that own small businesses. With regards to business management succession, I argue that a policy response might not be necessary if the business is in a highly competitive industry. In non-competitive industries, already existing antitrust legislation can be enhanced to incorporate measures to minimize the kinds of nepotism in business management succession that undermine equality of opportunity.

The essay will proceed as follows. Section I clarifies the key concepts of family businesses and equality of opportunity, and explicates the argument that family business succession has a negative impact on equality of opportunity. Section II then qualifies this argument with the problem of second best. Whether or not family business succession is harmful to equality of opportunity depends on certain circumstances, such as whether the family that conveys advantages to future generations comes from a disadvantaged or a privileged position. Drawing on this, Section III argues that policies to control business ownership succession should primarily target large family-owned firms instead of small family-owned firms, because the families that own the former have greater access to opportunities to increase their wealth than the families that own the latter. Section IV then argues that business management succession may not require policy intervention, especially when the company is in a competitive market. In non-competitive industries, already existing antitrust legislation can be strengthened to regulate business management succession as well. Section V concludes that the effects of family business succession on equality of opportunity are context-dependent, and that policy interventions should take these context-dependencies into account.

1. How might family business succession negatively affect equality of opportunity?

In order to see how family business succession may have a negative impact on equality of opportunity, it is important to clearly define both family business and equality of opportunity.

There are two important aspects to the definition of a family business: family ownership and family management. The precise definition of a family business in terms of these aspects varies, but there is a general consensus that the following features should be present: in a sole proprietorship or a partnership, family ownership and management simply entail that a family member is named as an owner-operator of the company. In a stock corporation, family ownership entails that a significant portion (i.e. one that would afford the family control and influence over decisions concerning the business) of the company's shares are held by family members, while family management entails that family members hold executive positions, or are in the company's board of directors. If a business is family-owned, family-managed, or both, then it is a family business. For an example of a more precise definition, Dieleman, Shim, and Ibrahim (2013, 8) posit that a family business is one where "(co-)founders or their family members are present among the 20 largest shareholders or as board members".

The succession of family businesses can also be understood by drawing on these two aspects. A business can be passed on to the next generation of the family in terms of ownership, management, or both. Business ownership succession involves the passing on of a business's assets (in a sole proprietorship) or of one's shares in the business (in a partnership or corporation) to a family member. Business management succession involves assigning a vacant leadership position in the company to a family member. It is important to distinguish between these two types of business succession as each will have different implications in terms of policy interventions to promote equality of opportunity, which I will now define.

In this essay, I use equality of opportunity in line with Haslett (1986, 128). He defines equality of opportunity as the "opportunity for all to pursue, successfully, the occupation of their choice". This definition is not only concerned with formal equality of opportunity, which posits that people should be judged solely on merit. Haslett's definition encompasses substantive equality of opportunity, defined as follows:

> Even if all are eligible to apply for a superior position and applications are judged fairly on their merits, [...] genuine or substantive equality of opportunity requires that all have a genuine opportunity to become qualified (Arneson 2015).

Under substantive equality of opportunity, anyone who wants to become a concert pianist must have the opportunity to acquire the necessary skills and social connections to be able to do so. However, Haslett acknowledges that this is an unattainable ideal that probably should not be fully pursued. Take, for example, parents who teach their child how to play the piano at an early age. They pass on advantages in terms of musical ability to their child, and complete equality of opportunity would prohibit them from doing so unless all other parents are also able to teach their children how to play the piano. I argue that this is an unacceptable result, because it impinges on parents' right to raise their children in the manner that they choose. It is important to keep this in mind when considering possible policy interventions that aim to promote substantive equality of opportunity.

How does family business succession negatively impact equality of opportunity? Let me take each aspect of family business succession in turn. Business ownership succession essentially involves the transfer of productive capital from one generation of the family to the next in the form of assets in a sole proprietorship or a partnership, and company shares for corporations. Owning these company shares means owning wealth that grows as the company itself grows. This, of course, also entails some responsibility on the inheriting family members: they have to ensure that the business remains profitable in order to increase the value of their company shares. These responsibilities, however, are minimal (e.g. voting on certain issues and electing directors). Given that they acquire this productive capital asset that gives them financial gain (e.g. in the form of dividends or the ability to make loans using the asset as capital) with minimal responsibilities and without cost to themselves, inheriting family members are given an unfair advantage over others who would have to have a substantial amount of savings in order to be able to acquire such productive capital. Moreover, this problem becomes cumulative because with these financial gains from holding shares of the company, the inheriting family member then has even more capital to invest, and thus to profit from. Those without the opportunity to inherit such productive capital will be even further left behind.

Business management succession is said to negatively impact equality of opportunity in two possible ways. The first is when family members are given an advantage over equally qualified (or even better qualified) non-members of the family when appointing replacements for vacant positions left by retired or deceased family members. The second is that even when a family member is the most qualified, she might have come to be the most qualified because of advantages imparted to her by other family members. Thus, whether or not the family member inheriting the position in the business is the most qualified candidate, she is being given an unfair advantage over other potential candidates for the job.

2. Does family business succession always have negative effects on equality of opportunity?

In the previous section, I established that family business succession has potential negative impacts on equality of opportunity. From this, it is a natural step to argue that in order to promote equality of opportunity, family business succession should be prohibited or controlled in all situations. In this section, I will present an argument by Means (2016) against an unconditional prohibition or control of family business succession due to what he calls the problem of second best. I then use this argument to further specify under which conditions prohibition or control of business ownership and management succession would indeed promote equality of opportunity.

Means (2016, 951), drawing on the general theory of second best put forward by Lipsey and Lancaster (1956), summarizes the problem of second best as "[assuming] that the best course of action is that which most closely approximates the outcome under ideal circumstances". This is problematic because if it is not possible to satisfy all the conditions necessary for a system to be at an optimum, then satisfying as many of these conditions as possible might not be the best way to reach the second best to the optimum. Achieving this level might require the other variables to be at suboptimal values as well.

Let me put the problem of second best in the context of inequality of opportunity and family business succession. There are many conditions in the current socio-economic system that depart from the optimum of complete equality of opportunity. One of these suboptimal conditions is the ability of families to pass on family businesses to future generations, since it endows a certain level of advantage to those who are given management and ownership of these businesses. The problem of second best draws attention to the other suboptimal conditions, such as systemic inequalities experienced by specific groups of people, that also exist alongside the one that needs to be corrected. These other conditions might mean that taking away the ability of families to pass on family businesses to future generations actually brings the socio-economic system away from its goal of greater overall equality of opportunity.

I will illustrate a situation in which the best course of action may actually be to allow the suboptimal condition of permitting families to pass on business management and ownership to future generations to persist. In our hypothetical socio-economic system, I name the following, as specified above:

Optimum (O): complete equality of opportunity

Suboptimal condition 1 (SO1): family business succession

I then add another suboptimal condition to the system: the family that owns the business consists of migrants who arrived in the country without social connections, adequate material means, or acceptable qualifications for the new country that they moved to. In Southeast Asia, for example, a significant number of the family business founders were migrants from China who were under these exact conditions (Crawford 2000, 78). I then name this condition:

Suboptimal condition 2 (SO2): disadvantaged immigrant family

It is clear that, given SO2, eliminating SO1 might actually negatively impact O and allowing SO1 to remain might promote O. For example, parents who do not possess the social connections necessary to ensure a good professional career for their children would be able to compensate for that lack of opportunity by handing over the family business to them. In situations like these, allowing a business to be passed on to future generations actually promotes equality of opportunity by giving disadvantaged families a way to compensate for their unfavorable position over the generations.

It should be emphasized that Means' argument that I have presented here does not claim that allowing family businesses to be passed on promotes equality of opportunity absolutely, in all circumstances. His argument should be thought more of as a cautionary principle. It is important to base our judgments on whether family business successions promote or negatively impact equality of opportunity on real-world conditions, not on the notion of an ideal society with complete equality of opportunity. In other words, context matters. The next two sections will go into the policy implications of family business succession when these contextual factors are taken into account. Section III will examine business ownership succession in the context of firm size, and Section IV will look at business management succession in the context of industry competitiveness.

3. Ownership Succession and Firm Size

When considering business ownership succession, I argue that it is important to take company size into account. The size of a company is determined by different standards in different places, but two common measures used include the amount of capital that is invested in the company and the amount of revenue that the company generates. A family that owns a large company thus has large amounts of capital invested in a company that generates large revenues, and also has the advantage of economies of scale. This means that it costs less for the large family business to grow even bigger, and thus to increase the wealth of the family shareholders. Small family companies do not have the advantage of scale and have less capital that grows slower than in large family companies. Thus, families that own large businesses have access to more opportunities to increase their wealth than families that own small businesses. If improving equality of opportunity is a concern, then policies to control business ownership succession should target large family businesses more than small family businesses.

One policy to control business ownership succession is a death duty, which is essentially an inheritance tax to be paid on the value of the shares of the business being passed down. Bracewell-Milnes (1997) brings attention to the fact that death duties disproportionately harm small family firms, defined as sole proprietorships or partnerships that are unlisted, while leaving big family firms, defined as stock corporations listed on an exchange, virtually unaffected. In large listed firms, on the one hand, the inheriting shareholder is able to sell some of her inherited shares to cover the burden of the taxes that will be charged, while leaving the company unaffected. On the other hand, the small family firm will always be negatively affected by whatever the inheriting shareholder does in order to cover the tax costs. The inheriting shareholder can either have the company itself buy the inherited shares, which significantly weakens its financial position because of the large cash outflow this entails, or she can sell the shares to outsiders, which effectively means giving the firm away. Either option leaves the company at a disadvantage. I argue that policies that aim to promote equality of opportunity should have the opposite effect than death duties have: large family firms should carry a proportionally larger burden from policies that control business ownership succession than small family firms.

One such policy could be setting a certain limit, such as a maximum market capitalization (i.e. a maximum total market value of the company) for family business ownership succession to be permitted. This would mean that smaller family firms below the market capitalization limit would still be allowed to transfer ownership of company shares to family members without cost, while those above the limit might be progressively taxed. This might of course just incentivize family businesses to stay under a certain size. Moreover, this would entail additional monitoring and implementation costs beyond the costs of an unconditional policy to prohibit or control family business ownership succession. How, then, should such a policy be implemented? These issues concerning optimal taxation and its implementation are outside the scope of this essay. I am simply arguing that it should be clear that the policy being created is directed against business ownership succession in large firms and not in small firms. This makes it more likely that the policy promotes equality of opportunity instead of having a negative impact on it.

4. Management Succession and Competitive Markets

In the previous section, I have discussed a policy intervention to control business ownership succession in order to promote equality of opportunity. In this section, I will discuss policies that tackle business management succession. I will argue that under the condition that the business is in a competitive industry, business management succession to family members is not likely to compromise equality of opportunity. Thus, in competitive industries, policy interventions prohibiting transfers of business management might not be necessary to promote equality of opportunity. What I mean by a competitive industry is that there are many other companies selling the same good or service that the family business is selling, and that all of them are actively competing for greater market share. I will then discuss in turn each of the two ways business management succession is said to negatively affect equality of opportunity.

The first is when family members are given an advantage over equally qualified (or even higher qualified) non-members of the family when appointing replacements for vacant positions left by retired or deceased family members. If the business is in a competitive industry, it would be in the family's interests—as the managers of the company charged with ensuring its profitability—to hire the best person for any important position, whether she is a family member or not. This is because if they forego hiring the best person for the job in order to give the position to a less-qualified family member, then the best person can be hired by a competing company, which could mean weakening the family business' position in the market. There is evidence that the market mechanism may actually work in this regard: there is a strong trend towards hiring an outsider to take over the CEO or Chairman role to replace a family member in listed Singaporean family businesses (Dieleman, Shim, and Ibrahim 2013). Thus, in a competitive industry, there is strong reason to believe that when a family member is hired for a top position in the company, it is because she is the best person for the job. Prohibiting family business management succession would thus not be necessary.

The second way business management succession is said to negatively affect equality of opportunity raises an important objection to the argument I have just made. Even if the family member is indeed the most qualified, she has come to be the most qualified because of advantages imparted to her by other family members. Because she was being groomed to take on an important position in the family business from an early age, she was given access to social connections, together with company and industry-specific knowledge and experience that other people did not have access to. Prohibiting family business management succession would then remove incentives for family business owners to impart these advantages on to the next generation. However, even if family business owners were not able to pass on the company to their children, they are still, as parents, incentivized to expose their children to the workings of the business in order to give them general knowledge and experience they can use to their advantage in whatever profession they eventually choose. If it is precisely this imparting of advantages that is unfair, then that should be the target of a policy to promote equality of opportunity. However, prohibiting parents from passing on such business-related knowledge and experience to their children would be an impingement of their right to raise their children in the manner that they choose, as I have argued in the first section.

Another objection to the argument that controlling business management succession is unnecessary in competitive markets that may be raised here is that family members can also be hired for positions that are high-paying, but are not essential to the running of the business. The (in)competence of the people holding these non-essential positions would not substantially affect the business' market share. Thus, it can be argued that even being in a competitive industry would not hinder businesses from giving such non-essential positions to family members on bases other than merit. My response to this is that giving non-essential positions to family members hurts the efficiency of the business whether or not the industry is competitive. Furthermore, the more competitive the industry, the less inefficiency a company can accommodate before it becomes unviable. Thus, a competitive industry would also tend to minimize these non-essential positions being given to family members.

What about when the family business is not in a competitive industry, such as when it has some degree of monopoly power? A business in such industries would be able to set its prices at levels that allow it to endure inefficiencies resulting from incompetent managers and hiring family members for non-essential positions in the company. Should positions in such businesses be allowed to be passed on to or created for future generations? In order to promote equality of opportunity, the answer to both questions should be in the negative. When a less competent family member is hired instead of a more competent outsider, the market is not able to discipline the business by decreasing its market share precisely because it has monopoly power. This power also enables the business to keep raising its prices to compensate for inefficiencies that result from giving non-essential positions to family members. Existing antitrust policies that aim to promote fair competition in industries could be enhanced in order to take these considerations of nepotism and equality of opportunity into account.

5. Conclusion

In this essay, I have shown how policy proposals to prohibit or control family business ownership and management succession would benefit from taking what Means (2016) calls the problem of second best into account. In a society where there are multiple conditions that run contrary to the ideal of complete equality of opportunity, one cannot assume that simply removing a single condition, family business succession, will bring society closer to this ideal. Other background conditions must be taken into account to determine whether or not family business succession has negative impacts on equality of opportunity, and what policy interventions (if any) are best to take.

In terms of business ownership succession, firm size should be taken into account when implementing policies such as death duties. Families that own large companies, defined as listed corporations, own larger amounts of productive capital than families that own smaller businesses, defined as sole proprietorships or partnerships, and thus have greater opportunities to even further increase their wealth. Because of this, the effects of policies such as death duties should fall more on large family firms than on small ones.

In terms of business management succession, the competitiveness of the industry that the family business is part of is an important consideration in assessing whether policy interventions are necessary to promote equality of opportunity. In competitive industries, it is not in the family's interests as business managers to forego hiring a more competent candidate for a managerial position for a less competent family member. Thus, policy intervention is not necessary. In non-competitive industries, however, hiring a family member over a more qualified non-family member would not have the same consequences as in competitive industries. Thus, business management succession should be controlled in these cases. Existing antitrust policies could be enhanced to take these considerations of nepotism and equality of opportunity into account.

About the Author

Erica Yu (1994) was born and raised in the Philippines, where she graduated from an honors program in Economics at Ateneo de Manila University in 2017. After working for a year in data science, Erica decided to move to the Netherlands to study Philosophy and Economics at Erasmus University Rotterdam. Outside the university, you might find Erica running around the Kralingse Plas, training to break two hours for her next half-marathon.

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