CHAPTER 11

Lessons from Mature Economies: Family Firms in Continental Europe and Japan

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1 Introduction

As large firms with dispersed ownership and professional management have risen in the USA. since the early twentieth century, managerial control has been seen as the standard model of modern firms. However, family firms, which are often treated as an outdated model, never lost their significance. Small and medium-sized enterprises (SMEs), which are almost universally under family control, are one pillar of modern market economy. Famous examples including hidden champions in German, the network of "flexible specification" in Northern Italy, and global production networks dominated by Taiwan firms are all great examples of the significance of family firms in contemporary global economy. In addition to SMEs, many large firms in continental Europe, East Asia, and South America are also under family control. Especially in East Asia, rapid economic growth accompanying the tradition of familism has helped produce many large family firms that have great impact on global

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economy. Companies such as Samsung in South Korea, Li Kashing in Hong Kong, Toyota in Japan, and the Formosa Plastic Group in Taiwan are all family firms.

Despite their increasing significance, family firms in East Asia outside Japan are still lacking in long-lasting mechanisms to deal with succession and cope with social and economic transformation due to their relatively short history and immature legal environments. To create an economic environment that can foster long-lasting development, the knowledge about mechanism of control and succession for family firms in mature economies is crucial. The purpose of this chapter is to briefly introduce the possible mechanisms, especially those related to succession, of European and Japanese family firms. Then I discuss how these frameworks can help East-Asian emerging economies to build their own mechanisms.

2 Family Firms in Europe: An Overview

Large firms in continental Europe are more likely to be under family control than their Anglo-Saxon counterparts. While there are many definitions of family firm, in this chapter I use the definition by European Family Business (EFB), the organization affiliated with European Union whose purpose is to improve the governance of European family firms. According to EFB, firms have the following features are labeled as a family firm. First, the majority of decision-making rights are in the possession of the natural person(s) who established the firm, or in the possession of the natural person(s) who holds/hold the major shares in the firm, or in the possession of their spouses, parents, child or children's direct heirs. Second, at least one representative of the family or relatives is formally involved in the governance of the firm. Third, for listed companies, if the person who established or acquired the firm (share capital) or their families or descendants possess 25% of the decision-making rights mandated by their share capital, they can be label as family firms[1] (EFB, 2018).

In 2014, European Union's COSME Program (Competitiveness of Firms and SMEs) launched a six-year project to establish statistics of family firms in Europe. While this project is not finished yet, there are already many important information accumulated about European family

[1] http://www.europeanfamilybusinesses.eu/family-businesses/definition.

firms. According to EFB,[2] there were about 14 million family firms in Europe, which accounts for 70–80% of the total number of firms in 2018. Among firms whose employees are fewer than 50 persons, more than 80% are family firms. Their output were around half of the GDP in Europe.[3]

In terms of sectors, most family firms are concentrated in more traditional sectors such as agriculture, handicraft, construction, tourism, and retailer. The financial and high-tech sectors generally have a lower ratio of family firms, with some exceptions such as the financial sector in Spain. European family firms have the following features. First, their capitals are more likely from self-capital or banks rather than direct financial markets. Second, family firms are more likely to use informal processes for decision making. Third, family firms have a more stable social relationship and thus have stronger social networks and social capital. Hiring is more likely to be relation-based.

With regarding to SMEs, many large firms in continental Europe are also family firms. La Porta, Lopez-de-Silanes, & Schleifer (1999) analyzed twenty largest firms in 27 advanced countries and found that 30% of them can be labeled as family firms based on the definition of 20% shareholding by controlling families. Belgium, Sweden, Denmark, Swiss, Portugal, and Greece had higher-than-average ratios of family firms. In Belgium and Portugal about half of the large firms were family firms, and in Sweden and Portugal 45% of large firms were family firms. If the sample included medium-sized firms, the ratio of family firms rose to 50% in France, 40% in German, and 60% in Italy. Compared with the figures of 20% in USA and of almost zero in UK, family firms obviously had a more important role in continental Europe.

Furthermore, large European family firms shared some features with family SMEs. The most obvious one was firm networks. Though an increasing number of European firms shifted their governance structures toward the US managerialist model in the past two decades, cross-shareholding and interlocks are still more dominant in Europe than in the USA (Ferraro, Schnyder, Heemskerk, Corrado, & Del Vecchio, 2012). Even in Northern Europe where progressive legislation actively promoted board diversity, interlocks among traditional shareholding families were

[2] Overview of Family Firm Relevant Issues, http://www.europeanfamilybusinesses.eu/uploads/Modules/Publications/overview-of-family-business-relevant-issues.pdf.

[3] http://www.europeanfamilybusinesses.eu/uploads/Modules/Publications/pp---family-business-statisticsv2.pdf.

still stable. It reveals the robustness of family firms in European economy (Endling et al., 2012).

The reason why European family firms can survive through long-term economic and social transformation is closely related to their relatively mature governance mechanisms and organizational cultures. Thus, these mechanisms provide important lessons for East Asian family firms. Based on the typology developed by Amable (2003), I divide European countries into four groups: the social democratic model that includes Netherlands, Sweden, Denmark, and Finland; the continental model that includes German and France; the Mediterranean model that includes Italy, Spain, Greek, and Portugal; and the Anglo-Saxon model that includes UK and Ireland. Because family firms are relatively weak in UK, this paper focuses on Nordic, continental European, and Mediterranean models. I also discuss the Japanese model that provides an important comparison.

3 The Nordic Model

Based on Amable's (2003) typology, the Nordic and Low-Country model of capitalism has the following features. On the one hand, these countries have a strong history of pursuing equality and thus have high tax rates and generous welfare spending. Labor unions are also stronger. On the other hand, they also emphasize openness and innovation of their economic environments and do not favor protectionist policies. Family firms are highly institutionalized and play a very important role in the economy. In 2016, the Netherlands had 276,900 family firms, which represented 71% of the total firms. They hired more than 2 million employees. Among those family firms, the average number of employee less than 10 employees is the majority type (EFB, 2017a). In other words, most of the family firms in the Netherlands are the SMEs. Denmark government made a more detailed statistics and showed that family firms represented 60% of all firms. Family firms were especially prevailing in the service sector (72%), but were also very dominant in the manufacturing sector (57%) (EFB, 2017b). In Finland, family firms hired about 70% of employees in non-financial sectors. However, Finish economy was more concentrated on large firms and thus family firms only contributed to 39.9% of the total value created by the business sector (EFB, 2017c).

While most family firms in Northern Europe are also SMEs, large family firms in this area, especially in Denmark, have developed a unique institution to balance professional management and family ownership:

the industrial foundation. Many world-famous European firms, such as Borsch, Ikea, Maersk, Rolex, Calsberg, and Lego belong to this model. Especially in Denmark, one-fourth of companies and 60% of public listed companies were run by industrial foundations. In this model, controlling families do not own and control the companies. Instead, after the founder donated the ownership into one or more industrial foundations, the founding firm will be owned and controlled by the industrial foundations, and can be taken as foundation-owned firm instead of the family-owned firm.

According to Thomsen and Rose (2012), an industrial foundation is defined by the following features. First, shareholding families transfer their shares to industrial foundations in the form of donation. In other words, shareholding families cannot take their shares back once the donation process is complete. This is the major difference between an industrial foundation and a trust. Second, an industrial foundation has its own legal personality and the endowment is run by an independent board. Therefore, controlling families do not directly intervene with everyday operation of companies; the operation of an industrial foundation must be based on the protocol drafted at its beginning. Finally, unlike other forms of foundations such as charity foundation, an industrial foundation can realize their shareholder's right and participate in firm operation (Thomsen, 2017.

Industrial foundations have the following merits. First, it can avoid dispersion of shares and help controlling families prevent hostile takeovers. Second, this model of control allows more stable governance and development of long-term strategies. It is also compatible with long-term employment characteristic of European capitalism. Finally, foundation control allows combination of family succession and professional management. There are diverse models of foundation control. The first type is registered as a charity foundation which is used to control companies. The most famous example is the Indian Automaker "Tata." However, this kind of practice is not allowed in many European countries. The second model, which is very popular in Denmark, is business foundation. In this model, a foundation has no obligation to donate its revenue to charity and is allowed to be fully committed to corporate governance as the rules are clearly written in the protocol. The third type is a family foundation whose purpose is to maintain or to promote the well-being of the offspring of a family. The most important feature distinguishing it from a trust is that its operation must be based on the protocol. The everyday operation can be handled by hired managers or a member of the family (Hansman & Thomsen, 2017).

According to Thomsen (2017), foundation control has a long history and has flourished since the end of World War II driven by high inheritance tax in Northern and Western Europe. Donation to foundation has been an important means to reduce tax. While Sweden and Finland abolished their inheritance tax in the last two decades, Denmark are still maintaining high inheritance tax and thus donation to foundations is an attractive way for tax saving. Denmark has 1400 industrial foundations and the number keeps growing in recent years. Companies controlled by industrial foundations hired 250 thousand employees in 2004 and 350 thousand in 2010, and held shares whose market values rose from 260 billion to 350 billion DKK in 2011. In other words, the 2008 financial crisis did not compromise the scales and functions of industrial foundations but rather strengthened them. Given the high tax rate in Denmark, the fact that most globally competitive firms are controlled by foundations shows its important merits.

4 The German Model

Unlike many countries where family firms are largely concentrated in domestic sectors, in Germany family firms play a very significant role in export.

In the literature of comparative political economy, German is usually labeled as a typical case of coordinated market economy or Rhine model characterized by strong ties between large firms, unions and large banks (Amable, 2003). However, medium firms, which is called Mittelstand and mostly owned by families, are an often-overlooked pillar of German economy.

According to Institute for SMEs Research in Bonn (Institut für Mittelstandsforschung) (2012), in 2011 Mittelstands accounted for 42.5% of total export and showed their role in constituting the strength of German manufacturing. A typical Mittelstand has the following features. First, the number of its employees must be lower than 500. Second, in terms of corporate control and governance, it is generally dominated by founding families. Its management highly relies on senior employees. Third, unlike large firms whose governance is highly contingent on their relationship with banks, a Mittelstand limits their relationships with banks to pure borrowing. Finally, a Mittelstand tends to sustain stable employment and unions are generally weaker. Stakeholders including employees are important in governance. Mittelstands play no small part in domestic sectors, they were crucial in German's industrial strength and formed a more decentralized economic order before the rise of large firms in the 1970s (Berghoff, 2006; Herrigel, 1996).

According to Institut für Mittelstandsforschung Bonn (2012), there are 3.7 million firms and 99% of them can be labeled as Mittelstand. They contributed to half of German GDP and hired more than 15 million people, which was around 60% of all employees. The famous system of vocational training in German is also buttressed by Mittelstand. Unlike many countries where SMEs are concentrated on the service sector, a major feature of German Mittelstand is their focus on manufacturing, especially capital goods. Even during the Great Recession since 2008, the hiring and investment by Mittelstand continued growing and played an increasingly important role in German competitiveness. The Mittelstand model has the following advantages. First, thanks to their independent finance and stable management, many Mittelstand can develop long-term strategies without considering short-term financial markets goals. This advantage helps them avoid the worst impact of the financial tsunami in 2008. Second, their stable relationship with employees, related firms, and local communities allows them to focus on specific niches and social responsibility. The famous model of German "hidden champions," in which firms focus on specific niches to attain leading positions in the world, is mostly done by Mittelstand (Simon, 1992).

Some German family firms also adopt the model of Nordic industrial foundation. The most famous example is the Krupp groups (James, 2012). However, the majority of large family firms do not adopt this model but instead use direct family shareholding as the major strategy. On the other hand, in contrast to large firms whose governance is highly related with large banks, Mittelstands are more self-sufficient and highly reliant on family members for management. Recently, increasingly intense global competition triggered transformation for Mittelstand. Many Mittelstands hired more outside managers, established more inter-firm cooperation, and conducted more globalized operation (Berghoff, 2006).

In terms of succession, there are both advantages and disadvantages for Mittelstands. On the one hand, family succession is still the major challenge for the Mittelstand model. While the majority of them hope for internal succession, not every firm can fulfill their plans. According to report KFW (2018), 20% of German's Mittelstands, namely, eight hundred thousand family firms, were considering ending their business. Fourteen percent, around five hundred thousand firms, have plan for succession in five years. Among these firms, half of them plan to transfer the control to family members and forty percent were considering selling to outside groups. Twenty percent of them are considering giving control to employees. Half of them still lack concrete plans.

On the other hand, there has been a steady trend for Mittelstands to institutionalized governance, build professional management, and decrease the influence of founding families, while at the same time retaining the control for family members (Bergoff, 2006). The most important efforts are family constitutions and advisory boards. More than one-third of all family firms in Germany have company constitution, and also one-third of them have established advisory boards that can strengthen their management (Institut für Mittelstandsforschung [SMEs Research] Bonn, 2012). In other words, while German family firms are not as institutionalized as their Nordic counterparts, they are moving in the same direction.

5 The Mediterranean Model

The Mediterranean model of capitalism has the following features. First, it tends to have stronger government regulation for a variety of markets. Second, their firm and welfare system are built on more traditional systems. As a result, family firm played a much more salient role in Southern Europe. According to Italian Association of Family Firms (AIDAF), there were 784,000 family firms in Italy. They account for 85% of all firms and hire 70% of total employees. Italy is unique for having family firms with a very long history. Among the 100 oldest existing firms, fifteen are located in Italy. The oldest one can even be traced to 1000 years ago. Italian family firms rarely adopt the northern European style of foundation control. Banks have very limited influences on them. Two-third of family firms are operated by family members, the highest number among European countries. On the other hand, in Spain 78.6% of all firms were family firms. In agriculture, manufacturing, and construction, more than 80% were family firms. In 2013, they employed about three million employees, about 60% of total employees of the private sector (EFB, 2015).

Due to their unique structures and cultures, Italian family firms have received great attention from academia and have strong theoretical implications. In the 1980s, the Italian model of inter-firm networks was believed to be a remedy to mass production and the future model of efficient production. Piore and Sable (1984) suggested that SMEs in Northern Italy have successfully developed a model of "flexible specialization" that produces high-quality products in a flexible fashion and creates the competitiveness of Italian economy. However, because the Italian family firms are still concentrated on more traditional sector such as textile, shoemaking, furniture, machinery automobile, and so on, they are generally less internationalized. Many suspect that the recent stagnancy of Italian economy may be attributable to the limitation of SMEs. However, further studies show a more complicated picture; Italian family firms do not have worse performance than non-family ones (Culasso et al., 2012).

Italian family firms also face the problem of succession. Studies show that firms totally run by family members have worse performance than those hiring outside managers (Cucculellia & Micuccib, 2008). According to Family Firm Successful Succession (FBUSS), a project sponsored by European Union, there will be one million SMEs facing problems of succession in the next ten years. Because the Italian tax system is very favorable to family succession and thus encourages internal succession in firms. However, Italian family firms still face similar problems with those in other countries, including succession plans, training, corporate governance, and human resource, and so on. However, because Italian family firms have strong networks, deep-rooted family traditions, and long-term involvement in their individual sectors, successful succession is far from rare (FBUSS, 2016).

Recently many family firms in Italy and Spain began to make international expansion. Collia, Garcı´a-Canalb, & Guille´n, (2013) showed that when these family firms expanded, they maintained the trust formed earlier with firm partners but granted more freedom to managers to develop local strategies. In other words, some characteristics of family firms, including stable social capital, trust, and long-term strategies, are compatible with internationalization. Middle-sized family firms are also key players in economic transition. Some family firms were very internationalized and developed diverse strategies based on local environments (Pongelli et al., 2016). In other words, family firms in Southern Europe that have deep roots with domestic cultures were also experiencing transformation in the era of globalization.

6 Japanese Family Firms

The typical contemporary Japanese model of corporate governance is controlled by managers with life-time employment; in most Japanese large firms the board of directors is a stage of promotion of managers, not a group that is represented the relative power and control of the shareholder compositions. This model is different from either managerial control in the Anglo-Saxon world or family control in Europe and East Asia. Before World War II, Japanese Zaibatsus, including Mitsubishi, Mitsui, and Sumimoto, were all family firms. Controlling families used shareholding firms to control the whole business groups. After World War II, the US occupational authority dissolved Zaibatsu to avoid the resurgence of Fascism. The control of these large firms thus shifted to the hands of professional managers and gradually managerial control became the dominant model of Japanese large firms. Despite the gradual change of shareholding structures in the last two decades, this model of control did not change much (Lincoln & Gerlach, 2004).

Like most countries, most SMEs in Japan are family firms. According to the 2019 white paper on small-and-medium enterprises in Japan, there were 3.5 million SMEs and represented 99.7% of the total firms. Among those with business succession, 55.4% of the successors were family members, 19.1% were other members of the board or employees, and 16.5% were external firms. To avoid economic damages caused by failed succession, Japanese government launched several programs and policies to assist the SMEs on smooth succession (Small and Medium Firm Agency, 2019).

While family control is not the mainstream model for large firms, based on the definition of board participation, there are still several large family firms such as Toyota, Matsushita, and Sanyo, is legally taken as a "family"-controlled firm. The most important feature of Japanese family firms is their reliance on social norms to solve the problem of succession. There are two major norms. First, the unique system of adult adoption allows Japanese family firms to recruit talented managers to be successor in the form of adopted son. Second, the Japanese concept of community firms that treats a company as a large family allows Japanese family firms to integrate family members and professional managers.

The key feature of Japanese family firms is the unique system of adult adoption. While in most countries adoptees are mostly children, in Japan a great part of adoptees are adults, and in many occasions are sons-in-law.

Therefore, firm leaders of family firms can solve the problem of succession by adopting the promising managers or even arranging marriages between them and their daughters. By doing so, large family firms can combine the merits of professional management and the stability of family firms. Empirical studies find that listed firms run by adopted sons have better performance than those run by professional managers (Mehrotra, Morcka, Shimc, & Wiwattanakantang, 2013). An astounding example of using adoption as a mechanism of succession is the Kajima firm, a leading construction company in Japan. Kajima was built in 1840, and between 1912 and 1984, it was run by adopted sons with strong academic credentials. All of the four chairs of board during this period were all graduates of Department of Civil Engineering in Tokyo University and adopted after marrying the daughters of the Kajima family. Not until 1984 did the company have a successor that is a son of Kajima family. What is noteworthy is that this successor, Kajima Akikazu, was also a graduate of Tokyo University and also had a degree from Harvard University. In other words, while Kajima Construction is a typical family firm run by family members, these family members were chosen based on their merit rather than bloodline.

On the other hand, even for firms that are not necessarily labeled as family firms, the prevalent notion that employees (including managers) are members of a community rather than wage labors also enable managers and family members to cooperate in operating the firms. The most interesting case is Toyota. Toyota Kiichiro established Toyota in 1941. Between 1950 and 1967, the chairs of board were two professional managers. Between 1967 and 1994, the control went back to the hands of family members. Between 1994 and 2009, professional managers served as chairs of board again. The most recent successor is Toyota Shoichiro, the grandson of Toyota Kiichiro. He won the support from senior managers as the Financial Tsunami brought great uncertainty in 2009. In other words, how members of Toyota family participate in firm operation is highly contingent on the economic environment and dynamics in the company.

7 Implications for Emerging Economies

The experiences of family firms in Europe and Japan provide important lessons for family firms in emerging economies. First, even for countries with strong traditions of family firm, succession, social transformation and globalization are still major challenges facing family firms. One key factor determining the family firm's outcomes is the integration of professional management into governance of family firms. Because emerging economies are largely in the stage where most leading firms are controlled by founders, these issues, especially succession, are often overlooked and maybe a big challenge for the lasting of the firm. The experiences of successful European and Japanese family firms show that institutionalization, i.e., adding the formal succession mechanism or incorporating the informal social norm, is the most useful strategy to deal with these challenges. Both formal mechanisms such as industrial foundations in Denmark and family constitutions in Germany and informal norms such as business networks in Italy and community firms in Japan provide valuable tools to deal with internal succession and external challenges. The experiences in Europe and Japan illustrate the importance that the development of a family firm is highly interwoven with the institutional arrangements, formal and informal.

Second, for successful family firms in mature economies, another key measure to deal with challenges such as succession, social transformation, and globalization is maintaining long-term relationships with stakeholders, including employees, local communities, financial institutions, and other firms. While networks are essential for most newly founded firms, they are often abandoned in the process of succession. However, the trust and social capital generated by stable relationships with stakeholders are proven to be indispensable not only for coping with challenges but also for long-term growth. In other words, firm succession is not only about the transfer of property and control to the next generation of the family, but also the transfer of social relationships to the next generation.

In short, the experiences of family firms in continental Europe and Japan provide important implications for family firms in emerging economies. Managerial control is by no means the optimal model of corporate governance for all countries, and family firms are still compatible with rapid social transformation and globalization. While the US style of corporate governance, which is built on the assumptions of managerialism and superiority of financial markets, has strong global influences, both firm leaders and policymakers in emerging economies should pay more attention to other mature economies with strong traditions of family firm. Specifically, the experiences from Europe and Japan may be more applicable to countries with strong emphasize on family firms.

Especially successful family firms in mature economies often have a valuable advantage that is often lost in US-style management—long-term vision. As many emerging economies begin to face slowing growth and more complicated social transformation, the experiences of European and Japanese family firms may provide important lessons on long-lasting development of family firms in Asia.

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