Limits to Firm Growth: All in the Family?

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Abstract

In less developed countries, firms tend to be small and many are family firms. We build a model of joint production in which managers collaborate subject to limited contract enforceability. Such contractual frictions keep firms small and give rise to family firms because collaboration among family members is better sustained than among professional managers. However, family members have different productivities, which is a source of disadvantage due to complementarity in joint production. The degree of contract enforceability and families' size and productivity endowment determine the prevalence of single manager firms, family firms (with or without outside managers), and professional firms in the economy, as well as the firm size distribution and aggregate productivity. Our quantitative model based on Indian micro data shows that India's income per capital would be 7 to 16 percent higher if contracts in India were enforced as well as in the US. If family firms are not allowed in the model, this income gap increases by 14 to 20 percent, since family firms are a way of mitigating the contractual frictions. Dissolving all family firms results in an income loss of 1 to 3 percent to large wealthy families and small poor families. In addition, the mid-range of the firm size distribution hollows out and income inequality worsens. Finally, a policy reducing family sizes undermines the role of family firms in mitigating the impact of contractual frictions and hence reduces income per capita, which contrasts with the conventional wisdom on fertility and economic development.

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