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ECONOMIC Synopses

The Rule of Law, Firm Size, and Family Firms

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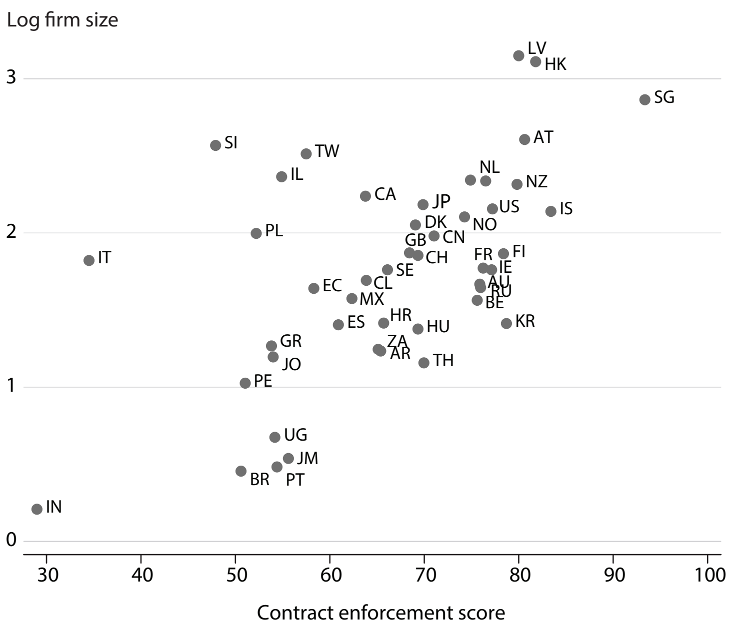
Less-developed countries tend to have smaller firms and establishments. For example, in the early 2000s, manufacturing firms in India had on average about 2.7 workers compared with about 40 workers in U.S. manufacturing firms. Firms in less-developing countries also tend to grow slowly, as pointed out by Tybout (2000) and Hsieh and Klenow (2014). Less-developed countries also have a higher fraction of family firms. We define a family firm as one with more than two managers from the same family.[1] Based on our sample, developing countries have a high fraction of family firms (e.g., 50% in India), while developed countries have a low fraction (e.g., 10% in the United States).

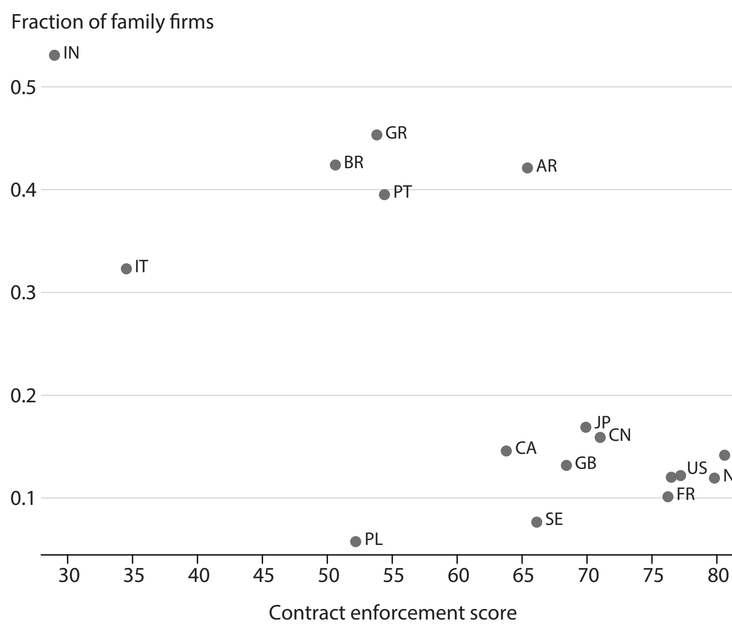
Recent work by Buera, Sanghi, and Shin (2022) relates firm size and prevalence of family firms to the rule of law. Advanced countries have a stricter rule of law, leading to better enforcement of contracts than in developing countries. For example, in 2005, enforcing a contract in India took about four years compared with about 10 months in the United States (per World Bank data). Figure 1 plots the relationship between contract enforcement and firm size. Contract enforcement is represented by a contract enforcement score based on the time to conflict resolution and procedures and costs.[2] Each dot represents a country in 2005. For example, Uganda (UG) and Brazil (BR), developing countries, each have a contract enforcement score of about 50 and smaller firms, while the United States (US) and Hong Kong (HK), developed countries, each have a score of around 80 and larger firms. Figure 2 plots the relationship between the fraction of family firms and the contract enforcement score. Countries with a lower score, such as India (IN), have a higher fraction of family firms,

Figure 1
Firm Size and Contract Enforcement



NOTE: Labels are two-letter country codes.
SOURCE: Global Entrepreneurship Management and World Bank.

Figure 2
The Fraction of Family Firms and Contract Enforcement



NOTE: Labels are two-letter country codes.
SOURCE: World Management Survey (subsamples from the organized sector of the economy) and World Bank.

while countries with a higher score, such as the United States, have larger firms and fewer family firms.

> Countries with a weaker rule of law tend to have more family-run firms, which tend to be small and grow slowly.

Buera, Sanghi, and Shin (2022) argue that weaker contract enforcement in developing countries causes firms in those countries to rely more heavily on family members, whom they tend to trust more than a manager hired from outside the family. This reliance on family constrains how big the firms can grow, leading to smaller firm size and a higher fraction of family firms compared with countries with better enforcement of contracts. In addition, drawing a substantial fraction of the management pool from a single family tends to be worse than drawing managers from the larger population. More reliance on family in management lowers the productivity of firms, further lowering the size of firms and overall development.

To summarize, developing countries have smaller firms, which have lower growth, and a majority of their firms are family firms, which centralizes decisions within these firms. Recent work argues that the prevalence of smaller firms and a higher fraction of family firms in developing countries could be an artefact of a weaker rule of law in these countries and quantifies the aggregate output cost of a weaker rule of law. Understanding the sources of the cross-country differences in the organization of production has important implications for employment, productivity, and economic output. ■

Notes

[1] In the World Management Survey, managers are individuals with line control of others; that is, they direct others' work and help set their pay.

[2] The contract enforcement score is the simple average of scores for three component indicators: the procedures, time, and cost for resolving a commercial dispute through a local first-instance court. A higher score means that the country has better contract enforcement and (i) fewer procedures, (ii) less time to a resolution, and (iii) a lower (percentage) cost to resolve a conflict. In 2005, this measure ranged from 30 for countries with weak enforcement such as India to 95 for countries with stricter enforcement such as Singapore.

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