CENTRE for ECONOMIC PERFORMANCE

POLICY ANALYSIS

Inherited Family Firms and Management Practices: The Case for Modernising the UK's Inheritance Tax

- What role does hereditary family management play in the long-standing poor managerial performance of UK firms? We address this question using a new survey of the management practices of over 730 medium-sized manufacturing firms in France, Germany, the UK and the United States undertaken jointly by the Centre for Economic Performance and McKinsey & Company.

- Analysis of the data reveals that firms that are family-owned but not managed by family members are typically well managed. An example is Wal-Mart, which is still largely owned by the Walton family but which has had a professional (non-family) CEO since the retirement of Sam Walton, the firm's founder.

- While family ownership seems to improve management practices modestly, family management by the children of founders is typically less good. When the CEO is selected by 'primogeniture' – that is, selecting the eldest son – the management practices of the firm tend to be extremely bad.

- The UK has a high share of family-managed firms who follow primogeniture practices compared with Germany and the United States. This arises in part from traditions dating back to the feudal society, but more importantly from the country's highly generous inheritance tax exemption of 100% for family firms, which make it possible for family ownership to remain concentrated and provides an incentive for even badly managed family firms to be kept within families.

- We believe this exemption should be modernised by introducing a cap on the relief of £1m, with this cap additional to the standard inheritance tax cap of £275,000. This would have several potential benefits:

    1. It should raise approximately £250m to help fund inheritance tax reform or other government spending priorities.
    2. It should improve productivity in the UK economy.
    3. It should improve intergenerational equity.
    4. It should bring about international alignment of the UK tax system.
    5. It should provide continued support for small and medium-sized family firms.

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Introduction

The UK's poor management practices have long been the butt of jokes, even going so far as to create a successful export industry in managerial self-deprecation through television series such as *Fawlty Towers* and *The Office*. Audiences from Slovenia to Paraguay have been entertained by what they presumably think of as the typical UK manager.

But while this lucrative sideline in TV comedy is one silver lining, there is a serious side as poor management has long been holding back UK economic growth and prosperity. For example, one Anglo-American study based on extensive tours of factories on both sides of the Atlantic claimed that:

> '… *efficient management was the most significant factor in the American productivity advantage…*'

What is worrying is not that this study was based on long and detailed examination of dozens of factories across the UK or the United States – or that it was carried out by renowned manufacturing management experts from both sides of the Atlantic – but that it was carried out fifty years ago as part of the 1947 Marshall Plan to reconstruct Europe.[1]

So it seems that poor management is as much a tradition in this country as warm beer and cricket. In fact, Alfred Chandler and David Landes – prominent Harvard business historians – have claimed that the UK's management problem dates back to around the 1900s.[2]

What could be causing this long-standing poor managerial performance of UK firms? Chandler and Landes argue that hereditary family management has played a major role, describing the way in which second and third generation family members run down successful businesses as a story of 'clogs to clogs'.[3]

But despite the prominence that such commentators have given to family firms, until recently, there has been very little rigorous cross-country analysis of their role. As a way of exploring this issue (and many other management-related issues), the Centre for Economic Performance at LSE and McKinsey & Company have jointly conducted a major survey of the management practices of over 730 medium-sized manufacturing firms in the UK, France, Germany and the United States.[4] Some of the surprising results are summarised in this analysis.[5]

Family firms and management practices

Analysis of the data reveals that firms that are family-owned but not managed by family members are usually well managed. This appears to be because family shareholders, who typically have large equity stakes, carefully monitor the managers they employ to run the business on their behalf. An example here is Wal-Mart, which is still largely owned by the Walton family but which has had a professional (non-family) CEO since the retirement of Sam Walton, the firm's founder.

[1] See Dunning, 1958.
[2] See Chandler (1994) and Landes (1969).
[3] Interestingly, the Chinese have a similar image: 'paddy-field to paddy-field'.
[4] See Bloom et al (2005a,2005b) and Bloom and Van Reenen (2006).
[5] See also Perez-Gonzalez (2006), who looks at 500 US firms and finds that when the current family CEO announces he is stepping down, the share price jumps if the incoming CEO is to be an external manager and falls if it is to be another family manager. If the incoming family manager is from a non-selective university, the fall in the share price is particularly bad. Bennedsden et al (2006) show that inherited family management is particularly damaging to firm performance for larger and faster growing firms.

While family ownership seems to improve management practices, family management is typically less good. There are two problems with family management:

- First, selecting the CEO from among the small group of potential family members severely restricts the available pool of managerial ability. While this may not be a problem for a small five-person firm, for a 500+ person firm, the CEO needs to be a highly able, which the family may not be able to provide.
- Second, letting family members know that they will get to manage the firm later in life can lead to a 'Carnegie effect', in which family members work less hard at school and early in their careers safe in the knowledge of a guaranteed family job.[6]

When the CEO is selected by 'primogeniture' – that is, selecting the eldest son – the management practices of the firm tend to be extremely bad. With primogeniture, both the lack of selection and the negative Carnegie effect become much more severe since the CEO position is determined from birth.

Family firms in the UK

Family firms exist across the world so why single out the UK?[7] From our survey of manufacturing, it turns out that the UK has a high number of firms that are both family-owned and family-managed.

The first row of Table 1 shows that the number of family-owned firms is about 30% in the UK, France and Germany and 10% in the United States. The second row shows that of these firms, the majority are managed by the family in the UK and France, but not in Germany. Moreover, the third row shows that about half of all these family firms in the UK reported handing down CEO control by primogeniture – that is, to the eldest son.

Table 1: Hereditary Family Firm Involvement by Country

%	France	Germany	UK	US
Family largest shareholder	32	30	30	10
Family largest shareholder and family CEO	22	12	23	7
Family largest shareholder, family CEO and *primogeniture*	14	3	15	3
Number of firms	137	156	152	290

Notes: Data from Bloom and Van Reenen (2006). Family shareholding is combined across all family members. Family involvement is defined as second generation family or beyond. Primogeniture is defined by a positive answer to the question '**How was the management of the firm passed down: was it to the eldest son or by some other way?'.

[6] The Carnegie effect is named after the great philanthropist Andrew Carnegie who claimed: '*The parent who leaves his son enormous wealth generally deadens the talents and energies of the son, and tempts him to lead a less useful and less worthy life than he otherwise would'*.
[7] Tom Nicholas – a (British) Harvard professor – has provided more recent data on the historical phenomena of family firms in the UK – see Nicholas (1999).

So what explains this high share of family-managed firms in the UK, particularly those that follow primogeniture practices? We believe two factors play a role:

- A tradition dating back to the feudal societies of the UK and France.

- Inheritance tax, which for a typical medium-sized firm worth $10m or more, contains no substantial family firm exemptions in the United States, but which has exemptions of roughly 33%, 50% and 100% in France, Germany and the UK respectively.

The feudal traditions of the UK and France appear to have persisted long after the feudal kingdoms themselves collapsed, with primogeniture obligatory under English law until the Statute of Wills of 1540 and de facto in France until the introduction of the Napoleonic code in the early 1800s.[8]

German traditions were based more on the Teutonic principle of 'gavelkind' (equal division among all sons). In the United States, the founding fathers were almost all younger sons of English gentry whose inheritance was given to their elder brothers by primogeniture, so they were never in favour of the practice. After the American Revolution, primogeniture was abolished, with equal treatment by birth order and gender common in the United States by the early 1900s.

The UK's inheritance tax exemptions for family firms were introduced in successive budgets between 1979 and 1992 by Chancellors Geoffrey Howe, Nigel Lawson and Norman Lamont..[9]

The UK provides by far the most generous inheritance tax exemptions to family firms compared with France, Germany and the United States. This makes it possible for family ownership to remain concentrated; it also provides an incentive for even badly managed family firms to be kept within family ownership.

A proposal for reforming the UK's inheritance tax

Privately held firms in the UK are currently exempt from inheritance tax. The large majority of these privately held firms are family firms. And family firms are also typically privately held. Hence, reforming the inheritance tax position for private firms links up very closely to the position for family firms.

We believe this exemption should be changed. One proposal would be to introduce a cap on the relief of £1m, with this cap additional to the standard inheritance tax cap of £275,000.

This would have five benefits:

- **It would raise approximately £250m to help fund inheritance tax reform**: The current costing on the private firms exemption is £280m. Firms over £1m account for 95% of the book value of all privately held firms, so that levying inheritance tax on this group should raise around £250m of extra tax revenue per year.[10] This £250m could either be used either to fund other government spending priorities or as part of the broader reform of inheritance tax.

[8] While the Napoleonic inheritance code enforced the equal division of *property,* it was more flexible with companies. A common route to pass property on to a single heir in France is to place this in a company. In England, *primogeniture* is also still common, with, for example, the 2005 Oxford English Dictionary stating that it is '*still prevailing in most places in a modified form*'.
[9] See the chapter by Paul Ryan in Glyn and Miliband (1994), which claims that the Conservative government introduced these exemptions in part due to a belief that family firms were good for the economy. Ryan also argues that the influence of wealthy families as political donors also played a role.
[10] The coverage ratios and assets ratios for private firms was calculated from the complete population of 1,700,000 UK firms from the FAME database.

- **It would improve productivity in the UK economy**: Our research shows that firms that are family-owned and managed have significantly worse management and productivity than firms with professional managers. The exemption on privately held firms provides a strong incentive for maintaining family ownership and management across generations.[11] While family ownership and management is by no means a bad thing, it is not something so good that the government should be subsidising it. Removing the family firms exemption would remove this distortion, leaving the decision for families and firms to make without any government influence.

- **It would improve intergenerational equity**: In international comparisons, the UK has one of the worst records in terms of the transmission of advantage and disadvantage from one generation to the next. We also know that intergenerational inequality has become worse in the UK over time.[12] The current structure of inheritance tax relief contributes to this inequality.

- **It would bring about international alignment of the UK tax system**: The proposed change would bring the UK into line with the US tax system, which currently provides around $700,000 *additional* estate tax allowance for family firms. France and Germany also have less generous exemptions from inheritance tax for family firms.

- **It would provide continued support for small and medium-sized family firms**: Around 90% of UK firms would be exempted by the £1m cap. The average private firm worth £1m has around 15 employees so that this would exempt small family firms, which represent the large majority of all family firms.

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[11] This problem can be summarised by the dilemma facing an ageing entrepreneur over how to hand down his private firm to his children. If he sells his business to professional managers and hands down the cash, this will bear 40% inheritance tax. If instead he hands down the company to his children – who based on the figures in Table 1 will typically end up running the company – no inheritance tax is due. Thus, even if his children end up destroying up to 40% of the value of the firm by poor management, it is still best from a financial viewpoint to hand down the firm within the family.

[12] See Blanden et al, 2005.

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