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The determinants of family firms' subcontracting: A transaction cost perspective

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ABSTRACT

In this article we compare the governance choices of family and non-family firms regarding their subcontracting tendencies. Based on transaction cost theory, we argue that family firms are less likely to engage in subcontracting than non-family firms and that kinship ties, the extent to which a family firm's production activities are important, and cost minimization concerns influence the extent to which family firms utilize subcontractors. Using a sample of small, established firms, we find support for our hypotheses as well as for the use of transaction cost theory logic to explain family firm behavior.
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1. Introduction

Family firms constitute a major portion of national economies throughout the world (Dyer & Handler, 1994). However, the focus of organizational research has been on non-family firms; as a result, investigating differences between family and non-family firms remains of primary importance in family business research because the differences are still unclear theoretically and practically (Dyer, 2003; Hoy & Verser, 1994). Since governance decisions play a critical role in firm performance and long-term survival (cf., Carney, 2005) and can help explain why family firms exist and prosper, it is a central dimension of how family and non-family firms may differ.

Transaction cost theory (TCT) is a theory developed to deal with the governance decisions of organizations and the efficient boundaries of a firm (Williamson, 1975a, 1981, 1985; Poppo & Zenger, 1998). Therefore, it is the theoretical framework this study uses to investigate how governance may be different in the two types of firms. Within TCT, a firm's choice between hierarchical governance, market-based exchanges, or hybrid governance (such as subcontracting) is determined by the extent to which a firm finds it more efficient to make or buy a product or service and engage in arms length or relational contracting (Walker & Weber, 1984; Williamson, 1981). Furthermore, the decisions to make or buy are affected by asset specificity, behavioral uncertainty regarding opportunism, and risk preferences (Chiles & McMackin, 1996; Gulati, 1995; Williamson, 1985, 1991).

One specific area that can cause systematic governance differences between family and non-family businesses is a firm's decision to subcontract. By subcontracting, we mean that the firm contracts with others to produce certain goods and/or services needed by the business. It could pertain to a single isolated event or repeated events. The latter requires long term and more involved transactions between the firm and the party to which the activities are contracted and is the subject of this study. It is a well-defined strategic choice and thus amenable to quantitative investigation. In addition, no study to date has focused on differences between family and non-family firms in the level of subcontracting and the specific family related factors that lead family firms to engage in subcontracting activities.

We combine the precepts of transaction cost theory and the literature on family firms to argue that family firms have different preferences toward subcontracting than non-family firms. We then test whether these preferences are manifested in decisions regarding the use of subcontractors. We also consider the factors that explain variations in subcontracting among family firms by examining the direct effects that (1) kinship ties with subcontractors, (2) the extent to which firm activities are important, and

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(3) cost minimization concerns have on family firms' preferences for subcontracting rather than internal production.

This study contributes to the family firm literature in the following ways. First, we use transaction cost theory as a theoretical lens (Williamson, 1975b, 1985) to show how the idiosyncratic propensities of family firms influence their governance decisions and to what extent these decisions are likely to differ from those made by non-family firms. This line of investigation enhances the development of the theory of the family firm and highlights the importance of incorporating transaction cost theory into family business studies (Chrisman, Chua, & Litz, 2004; Chrisman, Chua, & Sharma, 2005; Chua, Chrisman, & Sharma, 1999). Second, a theory of the family firm must be able to explain the differences between family and non-family firms plus the variations among family firms; but most empirical studies addresses only one or the other. This is one of the infrequent studies that examines both. Third, we answer the call for studies that help explain the governance decisions of small firms (Dewald, Hall, Chrisman, & Kellermanns, 2007). Specifically, we examine factors that influence the propensity of family firms to use subcontractors. We thereby contribute to a better understanding of variations in governance choices among both small and family firms.

The remainder of this article is organized as follows: First, the theoretical background and the hypotheses are presented. Second, the methodology is described. Third, the results are presented and discussed. In the final section, we provide future research implications.

2. An overview of transaction cost theory

Attaining cost efficiencies is the principal concern of transaction cost theory (Williamson, 1975b, 1985). Transaction costs are broadly defined as the "costs of running the economic system" (Arrow, 1969: 48). According to Williamson (1985), the contract is the key element of transactions, involving a transfer of goods or services between parties in an exchange. Williamson (1985) distinguishes between *ex ante* contracting costs such as the drafting, negotiating, and safeguarding of an agreement and *ex post* contracting costs such as maladaptation, haggling to correct misalignments, set up, operating, and bonding costs. These transaction costs influence the choice between markets, hierarchies, or hybrid (e.g., strategic alliances) governance structures (Walker & Weber, 1984). The efficacy of these choices depends upon asset specificity, uncertainty regarding the potential for opportunistic behavior among exchange partners, and risk preferences of decision makers (Chiles & McMackin, 1996; Gulati, 1995; Williamson, 1985, 1991).

Behavioral uncertainty derives from bounded rationality and agent's opportunism (Williamson, 1985). As Simon (1961: 24) argues, individuals behave "intendedly rational, but only limitedly so" since the information received may not be perfect and individuals do not have the time or mental capacity to fully process all available information. Accordingly, firms are unable to maximize utilities (Simon, 1955) and "contracts are normally incomplete" (Lafontaine & Slade, 2007: 649). This leads to satisficing behaviors (Simon, 1959) in the governance of transactions to avoid the unpredictable opportunism of economic actors (Williamson, 1985). Opportunism involves "self-interest seeking with guile" (Williamson, 1985: 47) on the part of agents, implying the potential for deception or incomplete disclosure with regard to either the ability of an agent to fulfill the terms of the contract or the willingness to expend the required effort. Firms will be more likely to prefer hierarchical governance as the possibility of opportunism in transactions increases.

The primary transaction cost element that affects the potential for opportunism and, hence, governance decisions is asset specificity (Williamson, 1975b, 1985). High asset specificity in the form of site specificity, physical asset specificity, human asset specificity, or dedicated assets leaves a firm vulnerable to opportunism owing to a lack of alternative exchange partners and/or asset uses (Williamson, 1981). Hence, when asset specificity is high, the cost of governing transactions through market mechanisms may exceed the potential flexibility and production cost benefits of subcontracting. In such cases, hierarchy is expected to be the preferred governance structure and studies have supported this contention (David & Han, 2004; Lafontaine & Slade, 2007; Poppo & Zenger, 1998).

Because of behavioral uncertainty, opportunism can rarely, if ever, be ruled out completely. As a consequence, management's risk preferences also influence governance decisions (Chiles & McMackin, 1996). Risk preferences develop based on personal and organizational factors (Chiles & McMackin, 1996; Laughunn, Payne, & Crum, 1980) and are defined as the "possibility of loss" (Yates & Stone, 1992: 4). Firms with greater risk aversion are more likely to select hierarchical governance than firms with lower risk aversion.

3. Hypotheses

Family firms are distinctive owing to family involvement in the ownership, governance, and management of the firm as well as their intentions for sustaining family control of the firm across generations (Chua et al., 1999). Yet, we still need a better understanding of how family involvement influences firms' decisions and performance (Chrisman et al., 2005). To contribute to this understanding, we use transaction cost theory to explain how and why the governance decisions of family and non-family firms might differ. We then outline specific antecedents of family firms' subcontracting in more detail.

3.1. Family firms versus non-family firms

Human assets are a key element of asset specificity (Williamson, 1985) and are particularly relevant to the governance decisions of family firms. Human asset specificity is dependent upon both the extent to which job skills are specific to a particular firm and the ease of measuring individual productivity (Williamson, 1981). The nature of the training provided to employees is one indicator of the extent of human asset specificity in an organization (Lafontaine & Slade, 2007). The human capital of family members in a family firm is developed through apprenticeships that differ from those available in non-family firms (Le Breton-Miller & Miller, 2006). "Learning-by-doing" type of training provided by senior family member managers to junior family members starts at home, continues through summer jobs, and extends into their professional careers. This family firm-specific training and experience imparts tacit knowledge and highly specific human assets that are not easily transferable or measurable (Penrose, 1959; Sirmon & Hitt, 2003).

In addition, family bonds can align interests and lower information asymmetries to decrease governance costs (Lubatkin, Schulze, Ling, & Dino, 2005). Altruism links family members' individual welfare to the welfare of the family and consequently fosters trust, communication, and reciprocity (Lubatkin et al., 2005; Stark, 1995). When altruism is reciprocal among family business members, opportunism can be mitigated (Chrisman et al., 2005) and this is expected to lead to work environments exemplified by greater employee care, loyalty, trust, and motivation (Habbershon & Williams, 1999). However, when altruism is asymmetrical, family members may have opportunistic tendencies (Schulze, Lubatkin, Dino, & Buchholtz, 2001). Nevertheless, Chrisman et al. (2004) note that such behavior may be consistent with the non-economic goals of family owners and therefore tolerated.

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