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"The state of monarchy is the supremest thing upon earth; for kings are not only God's lieutenants upon earth, and sit upon God's throne, but even by God himself they are called Gods …"

James I, addressing Parliament, March 21st 1609

Few would seriously argue that best choice for the next president of the United States is always the eldest son of the current one. Even considering all the siblings adds little to the proposal's gravitas. Nor are the best scholars of history or economics widely believed to be the biological children of current boffins; nor are NFL all-stars typically the children of past sports idols.

Why, then, do progressive societies, in which a university president can be fired for daring concede the academic possibility of a genetic component to ability (Dershowitz, 2006), entrust huge swathes of their economies to the sons (and very rarely the daughters) of family businesses? Does political correctness blind us to a truth James I saw (Herrnstein and Murray, 1994)? Do families pass along the wherewithal to run a great business more surely than business schools? Or are family businesses illiberal artifacts, feudal appendices persisting in the post-modern world until they cause inflammation?

The distinguished historian Harold James presents a delightful survey of the growing literature on family business, and on various rationales for its persistence devised by creative scholars in various fields. As might be expected of this author, the review is concise, accurate, and as thorough as can be expected in a short article. The reader is treated to well-written and thoughtful commentaries on huge literatures in economics, finance, history, law, and sociology, and to incisive critiques of their gaps and inconsistencies.

Prof. James concludes that entrusting the governance of businesses to families is by and large a good idea. He laments that "family firms are vulnerable to bad legal and tax regimes applied by governments at the insistence of analysts who wrongly argue that family firms are a sign of economic backwardness."

And although Prof. James carefully avoids mentioning genetics, biology arises with family business likened to a "biological organ" that at some times malfunctions, but that has an essential role at other times and cannot simply be excised. People do indeed come prepackaged in families, and economies must be built around this for good or ill.

Despite the professor's eloquence, I remain respectfully unpersuaded. My two main problems with Prof. James' arguments are that (1) they prove too much, and (2) they prove too little. I shall elaborate on each in turn.

The arguments "prove too much" because, in many sentences, one can substitute "government" or "university" for "business" to derive analogous arguments for absolute monarchy in politics or pervasive nepotism in academia. If family ownership brings long-term thinking, accountability, concern for reputation, access to networks, and the like to a business, why deprive the United States Government or Princeton University of such boons?

Libertarian wags might retort that governments and universities could learn a thing or two from even the most mismanaged business. But Western civilization ultimately rejected the arguments James I set forth for the Divine Right of Kings because absolute monarchy delivered unacceptably bad government. Absolute monarchies were deposed (or made into tourist attractions) across the Western World because the masses were profoundly unhappy, not "at the insistence of analysts who wrongly argue that [hereditary absolute monarchs] are a sign of [political] backwardness."

Those who would entrust economic power to elite families must either recognize this wider resonance or explain why hereditary governance elsewhere does not follow equally well. If hereditary corporate governance would prevent Enrons; would hereditary government prevent Watergates? Would hereditary professorships prevent discord such as sank Larry Summers' presidency at Harvard?

Restoring absolute monarchy is too illiberal for all but the staunchest American conservatives, and reflecting on why is helpful. Constitutional democracy clearly has its problems, but we are now fairly certain that all the alternatives truly are worse. The reasons for that consensus have analogs in economics that should give pause to advocates of hereditary economic power. Unseating families from government, eradicating nepotism, and imposing public education on the children of unwilling parents all check the power of families, and all are rightly lauded as major achievements in countries that have pulled them off. Life is better where accidents of birth do not dictate life's opportunities, and where people find their own places.

My second critique is that Prof. James' arguments also "prove too little." The literature he ably and eloquently reviews simply does not justify his conclusions that family control is good for companies, workers, or economies. Indeed, Bertrand and Schoar (2006), after an equally impressive survey of the literature (augmented by their own analysis of the data), end on a distinctly dubious tone (p. 80), "How much systematic evidence is there for the economic superiority of family controlled businesses? A reading of the empirical literature so far suggests: not a lot."

I find their skepticism more judicious for several reasons.

Many studies purporting to show superior performance by family firms use distinctly odd definitions of family firms. For example, a series of otherwise fine papers by Anderson and Reeb (2003, 2003a, 2004) includes Microsoft, Dell, and Yahoo! as family firms on because they are controlled by their founders, and might yet pass to a subsequent generation. Villalonga and Amit (2006) redo most of these analyses dropping "founder" firms, and find distinctly inferior performance among true U.S. family firms. Elsewhere, the superiority of family firms turns on comparisons with current and former state-owned enterprises. This is inevitable because, in many countries with weak shareholder rights, there are virtually no other sorts of firms to provide benchmarks.

The clearest evidence that family businesses outperform arises in the poorest countries. Indeed, the reason Anne Krueger's (1974) work comes up so often in the literature Prof. James so aptly surveys is precisely because she posits a highly plausible setting in which the greater prosperity of businesses saps the overall performance of the economy. Economists usually envision investment as e.g. a firm investing a million dollars in a factory to generate long-term profits of $100,000 per year – a ten percent return. Krueger rightly points out that an alternative investment in many countries is to use the million dollars to try to influence the government via connections, lobbying, political deal making, or even outright bribery. If this changes the regulations so as to leave the company $150,000 better off each year thenceforth, this is a fifteen percent

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return, and a more profitable investment for the firm. But a new factory would have increased the nation's wealth, while better political connections and regulatory favoritism generally do not.

Faccio (2006) painstakingly documents the extensive connections between old-moneyed business families and their governments, and argues that political investments by these families have exceptionally low costs and high returns. If the superior performance of old-moneyed family firms and the inferior performance of the economies hosting them have a common cause, the families' superior political investment returns, celebration should perhaps be somewhat muted.

While "family" virtues resonate emotionally and deeply, they may need refinement in a world capable of providing everyone with cheap iPods and tropical vacations. Prof. James rightly notes that long-lived family firms take few risks and generate relatively little wealth for the rest of the economy. But the iPods and tropical vacations are only possible because entrepreneurs took risks in developing new technologies and business models. This happened because liberal capitalism makes risk-taking relatively painless. Competition forces firms to innovate or be left behind. Capital markets protect investors from risk by letting them diversify across many companies. Labor markets protect workers by making it relatively painless to move from one firm to another. If we want the living standards delivered by incessant innovation, we must seek enduring community ties outside the workplace.

Ruing the rapid CEO turnover and shareholder myopia in professionally run firms, Prof. James posits that in family businesses "it may be easier to motivate managers and workers than in a setting when they do not know whether tomorrow the (faceless) owners will walk away." A tripartite response is in order:

First, average CEO tenure is now down to seven years (Kaplan and Minton, 2006). But firms that replace their CEOs more often perform better (Mikkelson and Partch, 1997) so it's hard to see this as a problem – unless you are a redundant CEO. Quickly replacing CEOs whose skills grow stale appears both amenable to the general good and emotionally satisfying to those of us not partaking of huge bonus and options packages.

Second, the persistent urban myth of shareholder myopia is also unsupported by the data. Firms' stock prices jump when they hike spending on physical capital (McConnell and Muscarella, 1985) or research and development (Chan et al. 1995) – both among the longest of long term investments – and market valuations of firms that spend more on R&D are unambiguously higher (Hall, 1993). Public shareholders jump to buy firms that invest for the long term! Stein (1988) argues persuasively that professional mangers prefer safer short-term investors, but must invest for the long-term to keep their share prices high to fend away corporate raiders. It's hard to see why the risk-averse family businesses Prof. James describes should act differently.

Third, the differences in labor relations Prof. James rightly notes may not flatter family business. French family firms do pay less across the board (Sraer and Thesmar. 2007), and family firms are more predominant in countries with stormier labor relations (Mueller and. Philippon, 2006). Perhaps workers at family firms accept lower wages for the transcendent benefits of an unmovable authority figure, as Prof. James suggests. But enhanced worker exploitation seems equally consistent with the data to date.

The strongest arguments Prof. James advances pertain to countries like Sweden. This economically successful paragon of egalitarianism entrusts over half of its large businesses, measured by market capitalization, to one family, the Wallenbergs (Hogfeldt, 2005). Family firms also loom large in Hong Kong, Singapore, and Switzerland. More work is needed to explain these exceptions to the otherwise clear negative correlation between family firm dominance and both equality and economic prosperity. Economic openness may be the missing link, for large firms in all these countries depend heavily on exports, and globalized competition may force their family firms to imitate their foreign competitors while better sheltered family firms in Latin America or the Middle East do as they like.

The strongest argument against this thesis is that corporate governance tends to faddish dandyism. In the 1980s, Japan was the paragon to emulate; and then its bubble burst. Before that, the world was hypnotized first by West Germany's Wirtschaftswunder and by the "Swedish Model"; but that was before eurosclerosis set in. In the 1990s, the United States allegedly had the world's best corporate governance, legal system, securities law, etc; but then came Judge Ito and Enron. We should not be fooled by transient problems into rejecting America's shareholder capitalism, Japan's sarariman managers, or Germany's watchful bankers and imprudently embracing "family business". A longer historical perspective shows a much greater spectrum of possibilities, and their strengths and weaknesses (Morck, 2005).

We do not need a new "flavor of the month" in corporate governance; and even if we did, family business would be a poor candidate. Countries that entrust the governance of more of their large corporate sectors to old-moneyed family provide lower standards of living, worse economic and social outcomes, worse government, and so on (Morck and Yeung, 2004; Fogel, 2006; Bertrand and Schoar, 2006). There are clear exceptions, most notably Sweden, but the negative correlation with family control is overwhelming (Morck, Wolfenzohn and Yeung, 2005).

The 20th century ran countless experiments to see what form of government works least badly. Unless things turn around unexpectedly, James I would have lost money betting on the absolute monarchy. The 21st century now gets to sort out what form of corporate governance works least badly; and I suspect Prof. James is premature in declaring for family firms. But then, a decade ago, I would have disparaged the idea that the 21st century would be riven by Wars of Religion …

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