

## Transaction Costs and Outsourcing Decisions in Small and Medium-Sized Family Firms

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### **Abstract:**

An important difference between family and nonfamily firms, and among different types of family firms, is in the way they make outsourcing decisions and thereby define the boundaries of the firm. The authors propose that transaction costs arising from human asset specificity, threats of opportunism, and risk aversion will make small- and medium-sized family firms operating with technologies of low to medium complexity less likely to outsource than comparable nonfamily firms. The authors also argue that the limiting influence of transaction costs on the outsourcing decisions of family firms may be mitigated by variations in available suppliers, goals, and ownership structures.

**Keywords:** family firms | outsourcing | transaction costs | entrepreneurship

### **Article:**

#### **Introduction**

Two fundamental questions about firms are why they exist and what determines their boundaries (Alvarez & Barney, 2004; Coase, 1937; Conner, 1991). Likewise, two related questions—why do family and nonfamily firms both exist and what determines the boundaries of these two types of firms—drive much of the research and theory on family business. Asking the second set of questions and providing some answers to a particular aspect of those questions are the objectives of this study. These objectives are important. Since family firms existed long before nonfamily firms, the emergence of the latter form of organization may be because the boundary decisions of family firms were in some ways inefficient or left certain societal needs unfilled, necessitating

the creation and growth of the younger nonfamily business sector. If true, then it also implies that nonfamily firms define their boundaries differently.

There are two dimensions that define a firm's boundaries. The first dimension deals with the kinds of businesses in which the firm is involved, whereas the second is about the set of productive activities that are conducted by the firm in a particular line of business. This study is about the second dimension—whether and why family and nonfamily firms make different decisions with respect to which productive activities to perform in-house. To date, family business researchers have investigated the boundaries between family and family enterprise systems within the framework of the firm's internal environment (e.g., Basco & Rodriguez, 2009; Distelberg & Blow, in press) but limited attention has been given to the boundaries between the family enterprise system and its external environment, which is the focus of our article. For the purpose of exposition, we use “outsourcing” to mean that the firm draws its boundary to exclude a particular productive activity and buys the needed products or services associated with that activity from an external supplier. We address two important research questions regarding family firm governance and outsourcing: (a) How do differences in the governance structures of family and nonfamily firms cause differences in their outsourcing decisions? (b) How do heterogeneities among family firms cause variations in family firms' propensity to outsource? As will be discussed in more depth below, we focus on small- and medium-sized firms that compete in industries using technologies of low to medium complexity because both size and technology can affect transaction costs (see Verbeke & Kano, 2010).

Transaction cost theory has been developed specifically to address the question about firm boundaries. According to transaction cost theory, asset specificity, opportunism, and risk preference lead firms to choose between hierarchical governance and market contracting (Chiles & McMackin, (1996); Geyskens, Steenkamp, & Kumar, 2006; Kim & Mahoney, 2005; Poppo & Zenger, 1998; Tsang, 2006; Williamson, 1975, 1985, 1991). These choices specify the extent to which a firm makes or buys the products or services required for its productive activities (Walker & Weber, 1984; Williamson, 1981, 2005). Thus, boundary decisions separate the activities conducted internally by the firm from those that are obtained from outside suppliers.

Apart from the fact that transaction cost theory is specifically designed to address the firm boundary question, researchers have proposed that family firms represent a variant form of the hierarchical governance structure in transaction cost theory (e.g., Carney, 2005; Gedajlovic & Carney, 2010). Therefore, this study relies mainly on a comparison of transaction costs to address the two research questions asked.

The study contributes to the literature by using the concepts of human asset specificity, opportunism, and risk aversion to explain why the propensity of family firms to outsource might be different from that of nonfamily firms. It adds to our understanding about how family and nonfamily firms are different. We further contribute to the literature by examining some of the contingencies that are likely to modify the preferences of small- and medium-sized family firms

for outsourcing rather than producing internally. By identifying these contingencies, we also improve our understanding about the heterogeneity of family firms. In short, we contribute to the literature by incorporating insights from transaction cost theory into the emerging theory of the family firm (Chrisman, Chua, & Sharma, 2005).

## **Transaction Cost Theory:**

### **An Overview**

Despite the importance of firm governance, transaction cost theory has been underutilized in the study of family firms. This is surprising because transaction cost theory is specifically designed to explain the governance decisions of organizations and the efficient boundaries of a firm (Kim & Mahoney, 2005; Poppo & Zenger, 1998; Williamson, 1975, 1981, 1985). In transaction cost theory, the principal factors affecting governance decisions under bounded rationality are asset specificity and opportunism (Geyskens et al., 2006; Tsang, 2006; Williamson, 1985).<sup>1</sup> However, recent studies suggest that risk preference can also be important (Chiles et al., 1996; Williamson, 1991). Williamson (1985) suggests that transactions are the basic unit of organizational analysis, involving a contract to transfer goods or services from one party to another. In a broader sense, transaction costs can be considered as the “costs of running the economic system” (Arrow, 1969, p. 48). Economizing on costs is central to transaction cost theory (Williamson, 1975, 1985) and economizing is achieved through the choice of markets, hierarchies, or hybrid governance structures (Leiblein & Miller, 2003; Walker & Weber, 1984).

As Table 1 shows, market transactions involve hard bargaining between parties whose identities are irrelevant because there is no dependency between buyers and sellers once the transaction is completed. Therefore, there is no risk of opportunism past the duration of the transaction and parties that behave in that manner can be easily replaced. Hierarchy is an alternative governance structure needed to perform the transactions internally within the firm’s boundary (Williamson, 1985). In hierarchical governance, a firm owns and/or controls the financial and human capital needed to perform the transactions required in its value chain (see Porter, 1985). The firm also can more easily access and accurately evaluate information that is created or acquired in the performance of the productive activity. Hence, by definition, hierarchical governance implies that the firm has relatively high control over transactions and their associated costs whereas markets imply that the firm has relatively low control. However, hierarchical governance requires the firm to set up monitoring and incentive systems to control opportunism within the organization. In hybrid governance, parties are autonomous but bilaterally dependent (David & Han, 2004) because contracts are long term in nature but still incomplete in the presence of bounded rationality. Identities then become relevant because the parties in the transaction must know who to go to when renegotiations and realignments are needed to prevent maladaptation. As Williamson (1985) argues, rational economic reasons exist for organizing transactions one way or another. We discuss these reasons in their general sense below without differentiating between family and nonfamily firms. Arguments about the differences between the two forms of firm governance are developed in the next section.

**Table 1.** A Comparison of Governance Structures

Governance Structures	General Characteristics
Market	Hard bargaining  Irrelevance of the identity of the parties  No dependency between buyers and sellers
Hybrid	Ownership autonomy accompanied by bilateral dependency of parties  Relevance of parties' identity in case of premature termination or persistent maladaptation  Incomplete contracts require special adaptive mechanisms for effective realignment and restoration of efficiency
Hierarchy	Internal organization  Incentive instruments that promote a team orientation  Easy access to and accurate assessment of information

*Note.* Adapted from Williamson (1991).

Transactions involve both ex ante contracting costs associated with the drafting, negotiating, and safeguarding of an agreement and ex post contracting costs related to maladaptation, haggling to correct misalignments, and setup, operating, and bonding costs (Williamson, 1985). Within the framework of the problem of contracting, the partner with the bargaining power (Blois, 1972; Coff, 1999) should have an advantage in minimizing both ex ante and ex post costs of contracting via dominance in negotiation, meaning that “the organization of economic activity is under the control of those who possess power” (Williamson, 1985, p. 124).

Williamson (1985) suggests that because individuals are boundedly rational, asset specificity and opportunism are important determinants of governance decisions. Bounded rationality suggests that individuals will behave “intendedly rational, but only limitedly so” (Simon, 1961, p. 24) because they do not possess perfect information nor the time or mental capacity to fully process information. With respect to governance decisions, this means that (a) firms are unable to maximize utilities (Simon, 1955) as neoclassical economic theorists claim (Savage, 1954), (b) information asymmetries exist between suppliers and buyers, and (c) “contracts are normally incomplete” (Lafontaine & Slade, 2007, p. 649). These bounds to the ability of decision makers inevitably lead to satisfying behavior (Simon, 1959) in the governance of transactions to deter the potential, but difficult-to-predict opportunism of economic actors (Williamson, 1985).

Opportunism involves “self-interest seeking with guile” (Williamson, 1985, p. 47) on the part of agents. Although bargaining in a transaction naturally involves the pursuit of self-interest on the part of both parties to an exchange, opportunism implies a certain amount of deception with regard to either the ability of a party to fulfill the terms of the contract (adverse selection) or their willingness to expend the required effort after the contract has been enacted (moral hazard). The more opportunism is a threat, owing to differential bargaining power and behavioral uncertainty in a particular set of recurring transactions, the greater the likelihood that a firm will opt for a hierarchical form of governance.

Asset specificity deals with the extent to which resources can be redeployed to other uses and entails site specificity, physical asset specificity, human asset specificity, and dedicated assets (Noteboom, 1993; Williamson, 1975, 1985). A fundamental premise of transaction cost theory is that high asset specificity leaves a firm vulnerable to opportunism owing to a paucity of alternatives available to redeploy assets in small numbers bargaining situations (Williamson, 1981). Therefore, the cost of governing transactions through market mechanisms when high asset specificity operates is thought to outweigh the benefits of flexibility and reductions in capital investments and overhead. In such situations hierarchy is expected to be more efficient and research has tended to support that contention (David & Han, 2004; Lafontaine & Slade, 2007; Poppo & Zenger, 1998).

Moreover, governance choices (Williamson, 1985; Walker & Weber, 1984) involve management’s ex ante evaluation of future outcomes (Chiles & McMackin, 1996). Risk is defined as the “possibility of loss” (Yates & Stone, 1992, p. 4). Risk preferences are based on factors such as individual dispositions (Laughunn, Payne, & Crum, 1980) and organizational culture (Morgan, 1986). The extent to which a firm is risk averse will exacerbate the influence of asset specificity and opportunism on governance choices (Chiles & McMackin, 1996), because at every level of asset specificity or possible opportunism, the associated risk of using a nonhierarchical governance structure will be less acceptable. Therefore, managers’ risk preferences (Williamson, 1991) should also influence governance decisions regarding outsourcing.

In summary, higher levels of opportunism, asset specificity, and risk aversion are expected to lower the propensity to engage in outsourcing. However, as Carney (2005) and Gedajlovic and Carney (2010) note, the characteristics of hierarchical governance under family control as opposed to nonfamily control will vary in terms of decision making and resources. In the next section, we extend this reasoning to explain why these characteristics will differentially influence more specific governance decisions such as outsourcing in family firms.<sup>2</sup>

### *Outsourcing in the Transaction Cost Context*

Before developing our arguments regarding how the governance choices of family and nonfamily firms affect their propensities to outsource productive activities, it is important to

discuss the determinants of outsourcing within the context of transaction cost theory. As already mentioned, we use the term outsourcing to mean the firm's decisions about the combination of productive activities to include within its boundaries.

Outsourcing is relevant only if the firm has the ability to produce internally and external suppliers also exist as a viable option. Therefore, our analysis assumes that this condition holds for both family and nonfamily firms. Furthermore, the outsourcing decision can be affected by other factors in addition to transaction costs. For example, the firm must compare differences in production costs as well as differences in transaction costs to make the outsourcing decision. Outsourcing decisions may also be affected by competition and market power in the supplier market, which may generate rents unrelated to transaction costs that are appropriable through internal production. In short, outsourcing decisions can be based on other factors besides transaction costs. However, since these factors seem unlikely to vary systematically among family and nonfamily firms, comparing outsourcing decisions from a transaction cost perspective is valid.

### **Governance and Outsourcing in Family Firms**

Family firms are defined by the involvement and control of a family in firm ownership and management and the potential ability and intention to achieve family-centered goals by maintaining transgenerational control (see Chrisman et al., 2005; Chua, Chrisman, & Sharma, 1999). Family involvement and family intentions in turn are expected to affect firm behavior with regard to opportunity pursuance and resource acquisition and deployment (Sharma & Manikutty, 2005; Sirmon & Hitt, 2003).

Family firms often possess family-centered noneconomic goals that include the perpetuation of a family's dynasty, values, harmony, and social capital, as well as the ability to behave altruistically to family members (Chrisman et al., 2005). Although achievement of such goals can reduce economic performance (Schulze, Lubatkin, Dino, & Buchholtz, 2001) they can create socioemotional wealth for the family (Gomez-Mejia, Haynes, Nunez-Nickel, Jacobson, & Moyano-Fuentes, 2007) and encourage transgenerational control of the firm (Chrisman, Chua, & Litz, 2003). Furthermore, unified family ownership and management (Gersick, Davis, Hampton, & Lansberg, 1997) leads to the parsimonious use of assets, superior and unconstrained control over firm-specific transactions, and the use of particularistic criteria in decision making (Carney, 2005). Put simply, the involvement and influence of a family in a firm leads to goals and the discretion to pursue those goals that generally do not exist in nonfamily firms. As discussed below, the differential reference point for economizing on transactions that characterize family firms shifts their indifference point between governance choices, thereby making them less likely to outsource than nonfamily firms.

Because our comparison of the transaction costs of these two types of firms largely depends on differences in the specificity of human assets, firm size and production technology are important considerations (Verbeke & Kano, 2010). Size is important because the comparison assumes that

the same production tasks may be managed by either family or nonfamily members. However, in large, professionally managed family firms, nonfamily managers occupy the majority of the management positions, making the comparisons of family and nonfamily managers of less relevance. Therefore, the discussion of transaction costs and outsourcing in this article is most pertinent to small- and medium-sized firms where family members are more likely to be involved in all

aspects of firm governance, management, and even operations.

The nature of the technology affects the analysis in two ways. First, as technological complexity increases, the assumption that the required tasks can be performed as efficiently and effectively by either a family or nonfamily firm becomes less valid because the pool of nonfamily members who can perform the tasks better than family members would be larger (Verbeke & Kano, 2010).

Second, the necessity and ability to meter how managers and employees perform productive activities is affected by the discretion the technology allows the operator. For example, if the technology allows the operator no discretion then opportunism would not be an issue. Our analysis assumes that the firms operate with a technology that is of low to medium complexity and allows sufficient discretion for opportunism to arise.

### *Asset Specificity and Opportunism*

Williamson (1981) draws attention to asset specificity as the most important factor governing transactions. As suggested above, this is because asset specificity increases the firm's vulnerability to the opportunistic behavior of suppliers or buyers, its ability to achieve competitive differentiation, and the difficulty of obtaining inputs from alternative sources

(Noteboom, 1993). Owing to their interrelatedness, we deal with asset specificity and opportunism together in this section.

Among the various sources of asset specificity, human assets are particularly pertinent to understanding the distinctive governance decisions of family firms since, as suggested above, family involvement and influence is the primary source of the differences between family and nonfamily firms and a potential source of competitive advantage (Habbershon & Williams, 1999). Human asset specificity is defined both by the degree to which aspects of human capital such as job skills are specific to a particular firm and by the ease of metering individual productivity (Pollak, 1985; Williamson, 1981, 1985). When job skills are highly transferable and metering is easy, employees can be hired and fired without a serious loss of productivity or high replacement costs (Williamson, 1981). On the other hand, when the value of human assets is largely firm-specific, or when metering employee productivity is difficult, hierarchical governance is thought to provide the most efficient governance structure (Williamson, 1981). As discussed below, family involvement leads to unique challenges and solutions in metering productivity as well as firm-specific human capital. We deal with metering first.

When metering productivity is difficult, the family form of organizational hierarchy has natural advantages over either the nonfamily form or nonhierarchical governance (Burkart, Panunzi, & Shleifer, 2001; Ouchi, 1980; Pollak, 1985). Transactions are embedded in relations that usually develop over time (Noteboom, 1996). Families are characterized by long-term relationships and in family firms, owners and managers tend to share family ties (Corbetta & Salvato, 2004; Zahra, 2003). In addition, family members are more likely to identify with the business and perceive a link between the fate of the business and their own well-being. The linkage among family members and between the family and the business tend to intensify commitment to the structure, procedures, and values of the firm (Ashforth & Mael, 1989; Craig, Dibrell, & Davis, 2008; Gomez-Mejia et al., 2007; Sharma & Irving, 2005). These characteristics of the human assets of family firms can reduce (but not eliminate) the possibility of opportunism and therefore the need for complex contracts, explicit auditing, and assessments that create transaction costs (Ouchi, 1980).

Another critical factor that increases human asset specificity in family firms is the pursuit of family-centered noneconomic goals (Chrisman et al., 2005), which generate socioemotional value (Gomez-Mejia et al., 2007). The pursuit of unique family-centered noneconomic goals (e.g., family harmony, family status, family dynasty, altruism) suggests that the skills and behaviors needed to achieve these goals will be more difficult to obtain in the marketplace and the attainment of these goals more difficult to evaluate (Chua, Chrisman, & Bergiel, 2009). However, such goals and behaviors, particularly altruism, which links the welfare of parents to that of their children, can also increase trust and communication and reduce opportunism. Although opportunism is less likely when altruism is reciprocal rather than asymmetrical (Chrisman et al., 2005; Lubatkin, Schulze, Ling, & Dino, 2005; Schulze et al., 2001; Stark, 1995), opportunism will generally be lower in family firms than in nonfamily firms even if



altruism is asymmetric (Corbetta & Salvato, 2004; Jensen & Meckling, 1976), a contention that has empirical support (Chrisman, Chua, & Litz, 2004).

Finally, family firms are also thought to be particularly adept at monitoring the behavior of family members owing to their close connections, superior knowledge about one another, and ability to use both organizational and familial sanctions to limit opportunistic tendencies (Pollak, 1985). Although altruism can negatively affect the enforcement of behaviors needed to attain economic goals (Schulze et al., 2001) it may contribute to the achievement of noneconomic goals. However, the ability of family firms to monitor the behavior of nonfamily employees or outside contractors for the achievement of economic goals should be no better or worse than that of nonfamily firms; it may in fact be worse owing to the tendency of family to use informal rather than formal methods for evaluating performance (Chua et al., 2009). Moreover, there is no offsetting noneconomic benefit to the family firm if outsiders shirk.

Thus, in situations where metering is difficult, the family form of organization should be more prevalent because of its advantages in controlling intrafirm opportunism (Burkart et al., 2001; Chang, Chrisman, Chua, & Kellermanns, 2008). Furthermore, although family firms are a response to metering difficulties, their governance structures also makes metering more difficult outside the sphere of influence of the family, which diminishes the desirability of outsourcing productive activities.

Proposition 1: The transaction costs of in-house production through hierarchical governance will be lower in family firms than in nonfamily firms as the difficulty of metering productivity increases.

Gedajlovic and Carney (2010) further note that some classes of assets, such as social capital, reputation, and tacit knowledge may be difficult to transfer across firms or replace through market transactions. Those authors argue that family firms are uniquely suited to develop and use these assets, which are largely embedded in the family's control and human capital investment in the firm.

Family firms have natural advantages in situations where specialized knowledge is developed through an extended period of training (e.g., craft industries). Unlike the case that exists in nonfamily firms, the human capital of family members in a family firm tends to be developed through long apprenticeships (Le Breton-Miller & Miller, 2006). The hands-on personalized experience gained via "learning-by-doing" between senior and junior family business members starts at home, continues through adolescence in the form of summer jobs, and extends through the career of family members in the firm (Le Breton-Miller, Miller, & Steier, 2004). When based on tacit knowledge gained through on-the-job training, the highly specific human assets of family members in family firms (Penrose, 1959; Sirmon & Hitt, 2003) are not easy to transfer or replace. Similarly, the longterm emersion of family members in the firm and the two-way flows of resources between the family and the firm (Arregle, Hitt, Sirmon, & Very, 2007; Sharma,

2008) should facilitate the development and utilization of social capital (Pearson, Carr, & Shaw, 2008) and reputational assets (Dyer & Whetten, 2006).

Thus, we propose that when the services of critical human assets are intangible, sticky to the firm, and difficult to replace (Gedajlovic & Carney, 2010), family firms will have an advantage over nonfamily firms. Moreover, given these conditions, and the advantages they generate, family firms are more likely than nonfamily firms to rely on hierarchical arrangements for governing their productive activities rather than market or hybrid governance mechanisms and consequently less likely to outsource their productive activities.

Proposition 2: The transaction costs of in-house production through hierarchical governance will be lower in family firms than in nonfamily firms as the importance of difficult-to-replace firmspecific human assets increases.

### *Risk Aversion*

Higher levels of ownership concentration have been associated with risk aversion in the family firm literature (Gedajlovic, Lubatkin, & Schulze, 2004; Schulze, Lubatkin, & Dino, 2002) and family business owners appear to be particularly risk averse (Gomez-Mejia, Nunez-Nickel, & Gutierrez, 2001; Romano, Tanewski, & Smyrnios, 2001; Schulze et al., 2001). Family firms are also parsimonious when using family wealth because it is their money and because such wealth is often not diversified (Carney, 2005). This may limit the scope of their activities and cause them to refrain from undertaking risky business ventures (Morck & Yeung, 2003). This aversion to risk appears to be especially pronounced when the activity threatens to reduce the family's control of the firm (Gomez-Mejia et al., 2007). Furthermore, as discussed above, family firms are likely to possess characteristics that increase the desirability of hierarchical governance and, conversely, the risk of outsourcing. Thus, although outsourcing might have the potential for cost and performance efficiencies, family firms appear to be more likely to perceive the risk of producing internally to be lower than outsourcing options even when the latter have higher expected values, especially when the family perceives threats to their continuing control of the firm (Gomez-Mejia et al., 2007).

Proposition 3: Family firms are more likely to be risk averse than nonfamily firms when evaluating the transaction costs of outsourcing productive activities.

### *Propensities to Outsource*

In the previous section, we argued that the transaction costs of in-house production through hierarchical governance will be lower in family firms than in nonfamily firms as the difficulty of metering productivity increases and as the importance of difficult-to-replace firm-specific human assets increases. We also argued that family firms will be more risk averse in terms of the transaction costs associated with outsourcing options. Since, according to transaction cost theory

the difficulty of metering suppliers' productivity, the limited ability to replace firm-specific human assets, and risk aversion will tend to deter outsourcing, we propose the following:

Proposition 4: Family firms are less likely to outsource than nonfamily firms.

### **Contingencies Affecting Outsourcing in Family Firms**

In spite of our contentions regarding their propensity to avoid outsourcing, family firms are not a homogenous population (Basco & Rodriguez, 2009; Melin & Nordqvist, 2007). Thus, we reason that certain contingencies will increase the likelihood of outsourcing among family firms. In this section, we deal with three important contingencies that capture essential features influencing family firm governance: the potential familial relationship between the owners of the firm and its suppliers, the importance of economic versus noneconomic goals, and the concentration of control in family firms. These contingencies get to the heart of the distinctions among family firms from a transaction cost perspective because, respectively, they address the ability to limit supplier opportunism, the influence of economizing relative to other goals on governance choices, and the ability of hierarchical governance to control conflicts of interest.

#### *Outsourcing With Kin-Controlled Firms*

As noted above, the threat of opportunism is considered lower among family members than among nonrelated individuals or economic entities, as family members are connected by "a common bond" and "a set of mutual expectations" and tend to engage in business relationships through "informal agreements based on affection rather than utilitarian logic or contractual obligations" (Gomez-Mejia et al., 2001, p. 82). Thus, relationships among family members are often perceived to be of higher value than economizing on transactions. Indeed, exchange often has a noneconomic social dimension (i.e., intrinsic utility) as well as an extrinsic economic utility (Noteboom, 1996) that will be particularly relevant to family firms.

Thus, we argue that family firms are more likely to outsource to suppliers who are controlled by individuals who share kinship ties with the owners of the focal firm. Kin solidarity and trust act as self-reinforcing social control mechanisms, constraining opportunistic behavior, thereby reducing the need for complex contracts and lowering the transaction costs of finding, negotiating with, and monitoring exchange partners (Gulati, 1995; Landa, 1981; Mustakallio, Autio, & Zahra, 2002; North, 1984, 1991; Peng, 2004). Social control mechanisms are in line with family firms' personal rather than formal approach and intrafamily monitoring abilities (Pollak, 1985). Lower potential for opportunism and less risk aversion toward suppliers with kinship ties can, therefore, increase the likelihood of family firms' outsourcing.

On the other hand, the parties in impersonal exchanges are more likely to take advantage of each other, necessitating specific and precise contracts and costly measures to enforce compliance (Macher & Richman, 2008; North, 1984). Despite contractual safeguards, bounded rationality makes it difficult to distinguish trustworthy individuals from untrustworthy individuals (Macher & Richman, 2008). As a result, an untrustworthy supplier's nonfulfillment of contractual terms

can prevent a firm from meeting its customers' orders or demands (Choi & Krause, 2006; Lajili & Mahoney, 2006) and threaten the family firm's reputational and social capital advantages (Gedajlovic & Carney, 2010; Habbershon & Williams, 1999; Pearson et al., 2008). In addition to the loss of control and associated holdup problem, suppliers may eventually take advantage of the learning that occurs through the contractual relationship to become competitors (Mieghem, 1999). Suppliers may also engage in collusive activities such as price increases (Choi & Krause, 2006) and owing to bounded rationality and information asymmetries, the buyer cannot be sure whether the supplier is exerting sufficient effort to keep prices down (Kawasaki & McMillan, 1987). Thus, family firms that decide to outsource should prefer suppliers with whom they share kinship ties to reduce the risk of opportunistic behavior.

Moreover, particularism (Carney, 2005) in outsourcing with family members is also consistent with efforts directed toward transgenerational control, continued family involvement, and socioemotional wealth considerations (Chrisman et al., 2003). For example, outsourcing to kin-controlled firms may expand job creation opportunities for family members, which is often a primary goal in family firms (Kelly, Athanassiou, & Crittenden, 2000; Ram & Holliday, 1993), while still addressing the human asset specificity and risk aversion issues that normally work against the selection of the outsourcing option.

In addition, the exchange of inside information with kin-controlled suppliers should be easier and more likely to be mutually beneficial (Campbell, 1979; Demsetz, 1986; Healy & Palepu, 2001) owing to the family relationships that link the firms. Thus, both the family firm and its kin-controlled suppliers may have better and more personal knowledge about their partner's operations and personnel (Mustakallio et al., 2002), which can reduce the risk of poor performance and the need for close monitoring.

Family business members may also feel obligated to serve or help kin without expectations of immediate reciprocity (Chang, Memili, Chrisman, Kellermanns, & Chua, 2009; Karra, Tracey, & Phillips, 2006). Willingness to compromise and forbearance are common among kin to preserve family harmony (Hill, 1995). "Filial piety" (i.e., devotion and obligation to family) can enhance conformity and cooperative behaviors, which attenuate agency problems and transaction costs (Hill, 1995) in family firms. The filial piety of kin-controlled suppliers can reduce the risk of opportunism and potential loss of advantages based on human asset specificity.

For these reasons, we expect that the negative effects of human asset specificity, risk aversion, and threats of agent opportunism on the outsourcing decisions of family firms will be diminished when suppliers are kin-controlled.<sup>3</sup>

Proposition 5: Family firms with suppliers with whom they share kinship ties will perceive lower transaction costs in outsourcing and thus favor outsourcing more than those without such suppliers.

*Economic Versus Noneconomic Goals*

Transactions generate concern for the efficient use of resources (Walker & Weber, 1984) and economizing on transaction costs is assumed to be a primary goal in organizations (Williamson, 1985). However, organizations may have a variety of goals (Cyert & March, 1963). Although family firms are expected to place more emphasis on noneconomic goals than nonfamily firms, the degree to which they pursue economic and noneconomic goals (Chrisman et al., 2003, Chrisman et al., 2005; Sirmon & Hitt, 2003) will vary. When there is more emphasis on noneconomic goals than economic goals, family firms may be willing to forego the opportunities available through outsourcing in favor of maintaining control and providing opportunities to family members (Gomez-Mejia et al., 2007; Kelly et al., 2000). For example, owing in part to their noneconomic goals, family firms are expected to have greater difficulty in shedding resources and business activities than nonfamily firms.

However, when economic goals dominate, the tendency of family firms toward parsimony (Carney, 2005) may take precedence in decision making. When parsimony is the driving force, both production and transactions costs must be assessed (Williamson, 1985), and as Walker and Weber (1984) show, production costs are often more salient, particularly since they are more easily measured. Thus, outsourcing and other resource management practices (Sirmon & Hitt, 2003) that might improve efficiency will be of greater importance to family firms as their emphasis on economic rather than noneconomic goals increases. In this instance, a family firm's efforts to evaluate, shed, add, bundle, and leverage resources to attain competitive advantages (Sirmon & Hitt, 2003) will be more consistent with the transaction cost principles of economizing (Williamson, 1981, 1985).<sup>4</sup>

Family firms focusing on wealth creation will therefore direct greater efforts to improve quality, decrease production costs, and increase flexibility than increasing family harmony or providing jobs to family members. Assuming outsourcing offers such opportunities, the extent to which family firms emphasize economic goals will mitigate to some extent concerns related to human asset specificity, potential for opportunism, and risk aversion in family firms since some of these concerns emanate from the pursuit of noneconomic goals. As a consequence, the odds that the outsourcing option will be pursued should increase. In fact, outsourcing can improve a firm's coordination efficiencies and flexibility to respond to changes in demand and technology, both of which can shorten product development cycles (Leiblein, Reuer, & Dalsace, 2002). Outsourcing can also allow a firm access to a wider range of skills while allowing it to concentrate on improvements to its core competencies (Mieghem, 1999). By allowing short-term capacity adjustments in the face of demand fluctuations, outsourcing can reduce the firm's investments in facilities, equipment, and inventories (Atamturk & Hochbaum, 2001) as well as its business risk (Leiblein et al., 2002; Mieghem, 1999). Thus, owing to the potential cost saving and other advantages of outsourcing, we propose the following.

Proposition 6: Family firms that value economic goals more than noneconomic goals will perceive lower transaction costs in outsourcing and thus favor outsourcing more than those that do not.

### *Control Concentration*

Gersick et al. (1997) defines control concentration as the degree to which firm ownership is shared among family members. Concentrated control by a single family owner is the most common ownership configuration but sibling partnerships, where ownership is spread among a small number of closely related family members, and cousin consortiums, and where ownership is held by a larger number of more distantly related family members also exist (Carney, 2005; Gersick et al., 1997; Kellermanns & Eddleston, 2004; Lubatkin et al., 2005).

The propensity of family firms to outsource productive activities may vary depending on their ownership configurations. When family firms have low control concentration, participation and diversity in decision making should increase (Eddleston & Kellermanns, 2007; Kellermanns & Eddleston, 2004). On the other hand, in situations where ownership is concentrated among one or a very small number of family members, those in control have virtually complete authority. For example, in family firms that are still owned wholly or primarily by the founder, the founder-owner controls the information flow to others and shapes the family firm's strategic behavior and interactions with the external environment (Kelly et al., 2000). In such situations, family firms tend to function according to the values, missions, and visions established by founders rather than searching for new strategic approaches. Thus, family firms with high ownership and control concentration may focus more on internal issues such as improving functional expertise than on identifying external opportunities (Kelly et al., 2000).

Furthermore, when the firm is controlled by one or a very small number of individuals, the socioemotional value of maintaining family control may be greater because the potential successor is more likely to come from the founder's immediate family (see Gomez-Mejia et al., 2007). In contrast, in sibling partnerships potential successors may be dispersed among several nuclear families. The diminished probability that the successor will be a direct descendent of a particular owner may reduce the attraction of continued control. In cousin consortiums the family ownership group would include even more distant relations, some of whom may have little direct involvement in the firm. Finally, as control concentration decreases, goal diversity should increase. Thus, the possibility that noneconomic goals will generate socioemotional value for family members decreases as ownership becomes more diverse and dispersed.

As a transaction cost study by Walker and Weber (1984) shows, the power distribution and the amount of discretion decision makers exercise, may affect make-buy decisions. We expect that low control concentration in family firms can lead to the creativity and openness needed to adopt new approaches and take risks, such as outsourcing to achieve efficiencies (Williamson, 1981, 1985). Moreover, as control concentration decreases, interactions with outsiders tend to be more frequent and open (Kelly et al., 2000). Openness to external perspectives can facilitate the emphasis on finding and exploiting new opportunities outside the family business, such as outsourcing.

As control concentration decreases, family governance should tend to become more similar to the managerial governance that characterizes nonfamily firms (Carney, 2005). As interests become more diverse and family relationships become more distant, the possibility of opportunism within the family firm increases whereas the advantages of the human capital embedded in family membership may decrease. Moreover, as the relationships among family members become more distant, the ability to monitor and discipline family managers may be reduced (Leiblein & Miller, 2003; Pollak, 1985). If the risk of opportunism among family business members increases, the attractiveness of hierarchical versus nonhierarchical governance structures decreases, making outsourcing a more attractive option.

Proposition 7: The lower the control concentration in a family firm, the lower will be the perceived transaction costs of outsourcing versus in-house production and thus the more the firm will favor outsourcing.

### **Discussion and Conclusions**

Governance decisions influence the performance and long-term survival of all firms but little attention has been paid to family firms even though they constitute a major portion of the world economy (Dyer & Handler, 1994) and face many challenges that remain theoretically and practically unclear (Dyer, 2003; Hoy & Verser, 1994). In this article, we attempt to provide some initial answers to two important research questions that address one of these challenges: How do differences in the governance structures of family and nonfamily firms affect the outsourcing decisions in family firms and under what conditions do family firms decide to outsource? We propose that human asset specificity, opportunism, and risk aversion will make family firms less likely to engage in outsourcing. We then extend this reasoning by suggesting that the availability of kin-controlled suppliers, the importance of economic goals, and lower control concentration will be positively associated with family firms' outsourcing. Future research is needed, however, to compare outsourcing among family and nonfamily firms and empirically test the effects of the aforementioned contingencies on family firm governance. Such research can be accomplished either qualitatively or quantitatively by examining the value chains of family and nonfamily firms and by assessing the basis for the decisions on the productive activities performed in-house as opposed to those performed through market and/or relational contracting.

We contribute to the literature by using transaction cost theory to explain some of the differences in the governance of family firms versus nonfamily firms. We use outsourcing to illustrate these differences because such decisions get to the heart of governance decisions as reflected in transaction cost theory and are more readily testable and observable than the initial decisions that lead to the formation of family firms. Not only does this add to our understanding of family firm governance and provide avenues for future research, but it also suggests the value of the transaction cost perspective to family business studies. Our article also deals with some of the contingencies that might increase the propensity of different types of family firms to outsource. Thus, we have shown how the nature of the family firm might influence its boundaries without

assuming that the decisions of family firms are uniform. Both these contributions move us a step closer toward a theory of the family firm (Chrisman et al., 2005; Conner, 1991).

Transaction cost theory can be used to address other pertinent issues in family business studies. Apart from the factors that we have singled out in this article, there are likely to be other contingencies that affect the relative desirability of different governance structures in family firms. These include family culture (Dyer, 1988; Mieghem, 1999) and the extent to which the family firm has moved to a professional management structure (Chua et al., 2009). The impact of transaction cost factors might also vary in family firms depending on lifecycle stages, industry, or the imminence of succession. For example, when succession is close at hand outsourcing decisions may be affected by whether the intended successor is a family member or not, as well as the assessments of the incumbent regarding the capabilities of the successor. Furthermore, after succession has taken place outsourcing decisions may hinge as much on whether the new leader desires to preserve or break with the past (see Miller, Steier, & Le Breton-Miller, 2003) as it does on the relative importance of economizing on transactions. As with the other factors discussed in this article, these contingencies are likely to shift the perceived trade-offs between economizing on transactions and other goals.

Research is also needed to compare the performance of family firms that outsource with family firms that do not. As emphasized throughout this article and in the family business literature in general (e.g., Chrisman et al., 2005), such studies also need to consider that family firms seek to achieve a mixture of economic and noneconomic goals. Therefore, an assessment of how outsourcing or a lack thereof contributes to family harmony, employment opportunities for family members in the firm, and the general preservation of the socioemotional wealth of the family (Gomez-Mejia et al., 2007) should also be taken into account.

Although we focus on whether the governance structure of family firms will lead them to outsource, many family firms are also likely to become suppliers to nonfamily firms (Kimura, 2002). Since asset specificity can affect suppliers as well as buyers (Noteboom, 1993) and the governance structures of family and nonfamily firms appear to be different, research should also investigate the extent to which family and nonfamily firms become suppliers for other firms, as well as the performance implications of those decisions for both buying and supplying firms.

Finally, our transaction cost theory arguments have implications for family firm owners and managers. Since transaction costs can influence a family firm's governance decisions and these decisions in turn will influence family firm performance, our article can help firm owners and managers understand how to make more effective governance decisions. Perhaps the most important message of this article for family owners and managers, however, is that although economizing on transactions should be a driver of firm governance it is not the only factor that must be taken into account. Family firms pursue a variety of goals that sometimes conflict and sometimes are complementary (Zellweger & Nason, 2008). The better these goals are understood and articulated the better decision makers will be able to make informed governance decisions.



In closing, transaction cost theory helps explain governance decisions in family and nonfamily firms, as well as differences among family firms. Since such distinctions have theoretical and practical value, further work on how family firms economize on transactions is needed.

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### **Notes**

1. The unit of analysis in Williamson's (1981) transaction cost theory is the transaction. Therefore, whether the firm engages in a particular transaction frequently or infrequently is important and frequency of transactions is thus another dimension of transaction cost theory. Outsourcing is a decision worth analyzing only when the transaction is frequent and ongoing because of the inefficiencies associated with conducting infrequent transactions that require substantial investments in human and financial capital in-house. Thus, we assume that the outsourcing decision involves transactions that are frequent and ongoing for both family and nonfamily firms and do not deal with the frequency dimension in this article.
2. As suggested above, outsourcing can be conducted through either hybrid or market governance. However, since the most fundamental choice a firm must make is between hierarchical and nonhierarchical governance, we focus on that choice rather than the form of nonhierarchical governance a firm might select.
3. We also expect that outsourcing to kin-controlled suppliers will be through hybrid governance rather than market governance.
4. As suggested by Gomez-Mejia, Makri, and Larraza-Kintana (2010), the extent to which family firms weigh economic and noneconomic goals in decision making may be influenced by perceived hazards to firm performance if the status quo is maintained.

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