

## Chapter 2

# SMEs, Institutions, and Performance

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### ABSTRACT

*This chapter addresses at the outset the topic of SMEs and economic development from an institutions perspective. The authors argue that the transaction cost theory is not helpful towards understanding the role that institutions play for SME performance for several reasons. Instead, they argue for combining the resource-based theory with an institutions-based approach towards constructing a more practical and empirical oriented analytical framework. After the preliminary discussion and introduction to the different theories used, the authors then take a focus on the analytical framework used to study the relationship between the institution of competition, firm performance, and firm size distributions. This chapter studies the relationship between competition and firm size, whereas subsequent research could also involve the inclusion of other measures of institutions and firm performance.*

### INTRODUCTION AND BACKGROUND

In this chapter we argue that the transaction cost theory (Coase, 1937) is not helpful towards understanding the role that institutions play for SME performance in developing countries. Instead we propose an analytical framework that combines the resource based theory of the firm with institutional theory. This framework leads to the

somewhat surprising observation that institutions affect the value of firm-specific resources such as technology, labour and management. Because of the institutions some technologies may not be adopted and SMEs may be less viable due to an inherent favouritism in the competition institutions that shifts profitability towards larger scale, size and resource commitment.

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In development studies the aspects of the financial system or institutions have received overarching attention in relation to SME development, whereas the topic of competition and institutions has been relatively neglected (Schaper et al., 2008, Ardic et al, 2011). The objective with the empirical analysis is to establish whether more competition gives better conditions for the existence of SMEs in developing countries.

After the introduction follows in Section 2 a discussion of how institutions can be adopted into a dynamic understanding of firm performance. In Section 3 we then introduce the analytical framework that combines the resource based view with institutional theory. Additional introduction is given to different aspects of these theories in Section 3 as well. Section 4 discusses the data and methodological issues. The statistical results are presented in Section 5 followed by a brief discussion and conclusion in the last section.

Firm size could be thought of as long run performance measure according to some perspectives on firm size distributions. The relative importance that size has to firm and more aggregate economic performance also depends on the developmental perspective one has on SMEs. For example, according to Anderson (1982), who works within the paradigm of stages approach to development, SMEs are relatively more predominant at early stages of development, whereas larger firms will start to dominate in terms of employment numbers at later stages of development. In contrast herewith a more dynamic and population ecological perspective on firm size distributions (see e.g. Nelson and Winter, 2002, Schaper et al, 2008) would suggest that at any stage of development a 'healthy' rate of entry of new firms is important to keep industries alive and adept to new developments and innovation. This rate of entry will be determined partly by industry conditions and partly by the competition institutions. Furthermore a relatively large group of SMEs is necessary to foster the competition that will eventually lead to the selection process of a few winners that graduate

into becoming industry leaders. How good this selection process is e.g. in terms of international viability will also depend on the prior level of contestants among SME populations. Hence there would appear to be a self-sustaining relationship between competition and SMEs.

Here we argue that the exercise of 'unbundling' institutions (Acemoglu and Johnson, 2005) should not be taken literally in the sense that we necessarily need to move from the macro to the micro level in this exercise. Rather the unbundling exercise should be understood as one of moving from a superficial to a more thorough understanding of how particular institutions affect particular processes (such as value generation or production) and practices (behaviour) in the economy. This is for example why an industry-based approach (Porter, 1980) or the structure-conduct-performance paradigm may also have limitations towards extending our understanding of the workings of competition as a meta institution.

Traditionally competition has been seen as something internal to an industry following the structure-conduct-performance approach in industrial organisation. However, the evidence that industry only weakly explains firm performance is quite robust (Rumelt, 1991 and Hawawini and Subramaniam, 2003). At the same time does micro-economic theory lead us to believe that competition as an institution should be quite important for long run firm performance. Therefore, we argue and show with some simple empirical tests that competition may well be worth thinking of, not only as something internal to the individual industry, but also a type of macro or what we would rather call 'meta' institution (Kaplinsky and Manning, 1998, Ardic et al., 2011, Campbell et al, 2012). This should legitimise a research agenda of the effects of competition using a combination of firm and country or regional level data.

Our conception of competition as an institution in this chapter comes very close to what we traditionally and somewhat confusingly call 'competition policy'. However, this policy is

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