

Effect of Political Actors on Small Firms' Business Relationships and Performance

-A Case of EU and Swedish Small Firms

ABSTRACT

Despite the statement of many researchers and politicians on the vital role of SMEs for their contributions to GNP and employment, the research on SMEs relationship with political organizations is left almost untouched. This paper highlights the effect of political organizations like EU, on SMEs business performance. With emphasis on the effect of political unit on long-term business performance, the focus of this study is on how political units influence small firms. Employing business network theory, the stress is on the effect of political relationship and the connection on business relationship and finally business performance. It develops a theoretical view and examines how the coercive/supportive behaviour of political units affects directly and indirectly on business performance. While the direct effect refers to the direct relationship between the political and business units, the indirect relationship concerns the effect via coercion or support of business relationship. For the direct and indirect relationship effect on business performance the study has developed 4 hypotheses which will be tested by results from a survey involving from 134 SMEs in Sweden. Using PLS for statistical analysis, the article highlights the importance of a firm's business relationships in both being affected by coercive actions by political organizations and also in receiving the full benefit from their supportive actions.

Keywords: business performance, SMEs, business relationships, political connections, coercive and supportive behaviour, the European Union

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Introduction

Despite the statement of many researchers (e.g., Corbetta and Montemerlo, 1999) on the vital role of SMEs in both Europe and USA for their contributions to GNP, employment and wealth creation, the

research on SMEs relationship with political organizations is left almost untouched. The failure in incorporating the impact of political organization into the studies on small firms is founded in the view that small firms operate in local markets and have to follow the political rules, no matter where these political units are situated. This study postulates that small firms' business performance is confronted with uncertainty from not only their domestic country's political organizations but also from those in other countries or unions like the EU. The lack of studies on such business realities has motivated this study to focus on the question of how SMEs business performance is affected by the political organizations like the EU. Authors like Ring *et al.* (1990); Hadjikhani and Ghauri, (2001); Welch and Wilkinson (2004), claim that the scope of marketing literature contains no more than a handful of research, based on systematic investigations, pertaining to interactions between firms and political units. Researchers state that there is a considerable knowledge gap between the firms' practices of the political market and the availability of sound, research-based insights and principles. Furthermore, the available studies seldom touch upon SMEs and their embeddedness in the international political environment; and more specifically situations where SMEs are active in a local market and have no foreign operation. In line with this reasoning, the study by Hadjikhani and Ghauri (2001) demonstrates how Swedish firms make large commitments to influencing the political units in the EU before political decisions are made. To explicate, the higher the influence, the more specific support the firms gained.

Research on business network theory, like the studies of Welch and Wilkinson, (2004) and Hadjikhani and Thilenius, (2005), promote the view that the business performance of a business unit is related to its business relationship and connections. In this vein, the theoretical foundation of this study is composed of three analytical units; the firm's business performance, the focal business relationship and the political connection. The firm's business performance is proposed to be affected by the political connection both directly and indirectly through the impact on the focal business relationship.

The effect of political units can be studied their coercive and supportive actions towards the business firms (Hadjikhani and Thilenius, 2005). In the few available studies, SMEs are explained as being adaptive because of their resource scarcity (Ojala and Tyrväinen, 2008; Hadjikhani *et al.* 2006). While large business firms have organized units and commit resources towards the political organizations, SMEs have to undertake costly, adaptive actions (Prashantham, 2005; Hadjikhani and Ghauri, 2001). One major goal of SMEs in their interaction with political units is to avoid uncertainty and gain support for their businesses. Tackling the political environment is vital as SMEs, contrary to large business firms, do not have sufficient internal resources. While MNCs can undertake proactive actions to manage the political uncertainty and gain support, SMEs are regarded as being passive and adaptive.

SMEs have been extensively researched in many different fields. While some studies concern issues like entrepreneurship in international environments, or the role of social capital for small firms (Westerlund and Svahn, 2008), others concern topics like internationalization (Coviello and Munro, 1997; Hohenthal, 2001), and foreign market entry (Ojala and Tyrväinen, 2008). These attempts reflect issues like SMEs and the firm-level factors such as resources and knowledge (see for

example, Bell 1995, Prashantham, 2005). The vital role of SMEs and political impact has recently drawn the attention of some researchers (Hadjikhani and Ghauri, 2001; Crane and Desmond, 2002). In these efforts the environment of SMEs reflects business issues like production scheduling or firms' strategy and environmental uncertainty or the manufacturing environment, using technical and financial risk management. The political environment is studied by the hierarchical power of political units on manufacturing or financial issues. In the views developed, the unit of analysis is the firm and not the business relationships. Further, the uncertainty that reaches SMEs emanates from local, often domestic, political units.

A study like this one can contribute knowledge not only to the research community but also to the SMEs, managers and practitioners, who thus gain a more systematic understanding of their relationships in the socio-political market. The present study goes beyond this mainstream and assumes that SMEs are interwoven in a network containing both business and non-business actors (Welch and Wilkinson, 2004). As stated by Welch and Wilkinson (2004) such interdependency calls forth studying how political organization effect on business firms.

Theoretical Frame and Hypotheses

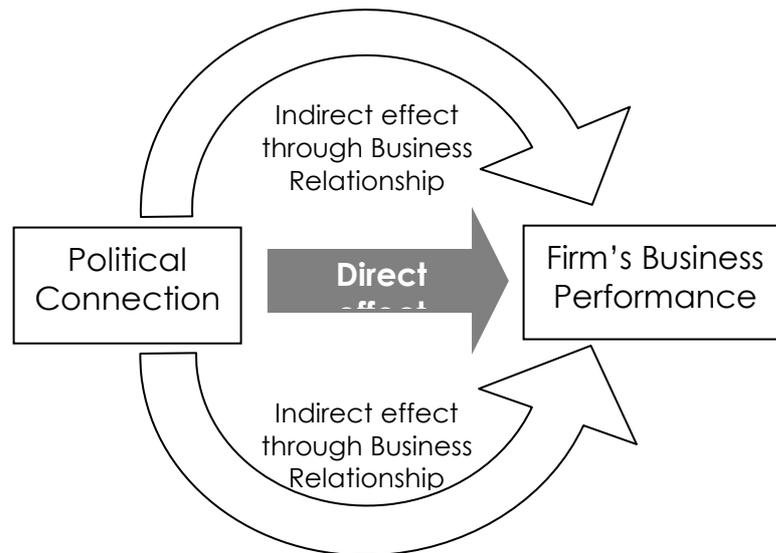
Constructed on business network theory (Håkansson, 1999; Ford, 1990) this study frames the link between business performances and the political relationships. It departs from the view that mutuality and long-term relationship in business network theory contains a function that preserves the gain of each of the individual firms. It rests on the view that long-term business performance of every business unit is prerequisite to operate in a business network context. The presumption sets business performance in focus while relationships and network activities occur as means to preserve the firms' long-term gain. Following the statement of researchers like Welch and Wilkinson (2004) and Hadjikhani and Thilenius, (2005) business network context is explained to encompass relationships with both business and non-business actors. In this vein, business firms are interdependent on the political actors as they can gain support or be hindered, and political actors are directly and indirectly interdependent on SMEs as they are the major source for the increase in GNP, jobs and the development of local industries. Thus, the business performance of each individual unit is in this context an outcome of the relationships with actors belonging to different structures. Business performance relies in this perspective on the effects from both business and non-business interactions. The view is delimited to studying the so called 'political market' while denoting the effect of political actions on business performance. It follows the assumption that political actors have two possible routes of interaction with every individual business actors. Business performance is in one way affected by the direct relationship between political and business actors and in another way through by the connection via the business relationship. The political connection can either be supportive or coercive. The effect of this connection can either be direct or indirect through the connection to business partners. Business performance is regarded as an output of the firm's direct relationships with business relationships and by the political connection.

With emphasis on firms' performance researchers like Hsu *et al.* (2008) state that business performance as antecedent to the firms' relationships and network. Business performance, viewed in

this perspective, highlights the issue of longevity in business development. Rather than financial performance, revenues, market shares and return on investments, measures (Rust *et al.*, 2004) relating to short-term performances, business capabilities and aspects like non-financial performance are elevated as alternatives for the study of business performance (Tseng *et al.*, 2009). Indicators like capability in product development and technological development (Ford, 1990; Håkansson, 1982) or knowledge development in the firm (Olavarrieta and Friedman, 2008) which explain the business long-term growth and survival of the firms are well disposed to measure the business performance. In this study, these indicators are presumed to be effected not only by business operations but also by the effect of political relationships.

The notion of political effect relies on assumption that political actors are dependent on SMEs as firms make investments that affect realm of the political units and that these firms are dependent on political units for their support and for market stability. Following the reasoning on business relationships the actions of political organization can be explained as coercive or supportive behaviour in the relationships while the act of business units can be observed as influence or adaptation. Supportive actions are assumed to promote the enhancement of the firm's business performance, while coercive actions are associated with the contradictory reduction of the business performance. The notion of coercion implies the exercise of legitimate power to force business firms to follow the political decisions. The adaptive behaviour of SMEs will eventually increase the costs and reduce the business gains. The supportive rules or financial support on the other hand will have positive effects and increase the firms' performance. The Green Paper of the EU in 2001, for example, concerns the issue of an integrated product policy (Zackrisson, *et al.*, 2008), an attempt to support in some fields and hinder in other fields. The effects of political coercive actions on MNCs are presumed by some researchers to be lower compared with SMEs. SMEs, because of their size and low managerial resources, have to adapt their organizational structure and business relationships (Hadjikhani and Ghauri, 2005). However, these firms also make investments in fields like lobbying to affect the political units (Hadjikhani and Thilenius, 2005a; Hadjikhani and Ghauri, 2001; and 2008). Some, like Henisz (2003), and Coen, (2001) presume lobbying and influence on political organizations (Ghauri and Hadjikhani, 2006) as managerial actions to build relationships with these units and gain support. In a relationship setting, the possible actions are to; a) change the coercive behaviour or; b) strengthen the supportive behaviour (Hadjikhani and Ghauri, 2001). The accumulation of coercive/supportive and adaptation/influence in this interaction is manifested as positive/negative consequences on the firm's business performance. Furthermore, this accumulation of behaviour can be the result of direct effects on business performance or indirect effects through business relationship. In Figure 1, the political connection's effect on firms' performance is illustrated as two functions, one direct on focal firms' business activity and one indirect mediated by the business relationship support and coercion.

Figure 1: Political Connection and the effects on firm's business performance



Accordingly to Boddewyn (1994) and Easton (1992) direct and indirect functions can have positive or negative effects on business firms. While supportive actions promotes the business performance and gains, coercive actions reduces the business gains. The coercive view implies the exercise of legitimate power to force business firms to follow the political decisions. The first hypothesis concerns the direct function which implies that political actions contain a degree of specificity with directly effect on each business units individually. Undoubtedly, for the relationship logic this will in turn effect on business relationship (this effect is not included in this study). In terms of relationship, business firms' undertake actions to gain specific influence by either lobbying/negotiation or are to adapt themselves. While the primary action, like negotiation is to keep the mutuality in the relationship, the latter manifests a coercive relationship. The assumption in the relationship between the political and business firms is to connote the degree of direct effect on business performance. This relies on specificity in the relationship between the two. Obviously, this effect will subsequently create obstacle or new opportunities for the firms' business relationship. The hypothesis in the following regards this direct effect and mean to study the strength of the direct effect of political connection on firm's business performance.

Hypothesis 1: The stronger the political connection the higher the direct effect on firm's business performance

The indirect effect resides on the logic of business network as any action of the interactive parties affect and become affected by political units. Specific or general effect from political units on interactive parties' relationship will ultimately effect on business performance. No matter the degree of the specificity or the degree of the strength in coercive or supportive act of political units, business relationship becomes affected. While some actions strengthen the business relationship, others weaken it. Supportive behaviour can aid business relationships and strengthen them while coercive behaviour on the contrary can weaken them. Ultimately, each of these imposes specific effects on business performance. Business relationships function in this line of reasoning is as a conduit

creating indirect effect of political connection on firm's business performance. Firms' long-term technological investment for new technologies and product development or even short-term return on investment, is postulated as an outcome from relationships with both business and political actors. In this regard the following three hypotheses refer to two different aspects. One is in regard to the effect of political connection on the business relationship and the other two refers to the direct effect of political connection on business performance via the business relationship. The first examines the strength in coercive and supportive behaviour on business relationship strength. The next two concerns the strength in the political effects in support or coercion of business relationship and then on business performance.

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Hypothesis 2: *The stronger the political connection, the higher the effect on business relationship support and business relationship coercion*

Hypothesis 3: *The stronger the political connection, the higher the indirect effect mediated by business relationship support on firm's business performance*

Hypothesis 4: *The stronger the political connection the higher the indirect negative effect mediated by business relationship coercion on firm's business performance*

Method

This research is part of a broader project aiming at substantially increasing our knowledge on the effect of political activities towards business actors and the effect on business relationships and firm performance. In this context, a questionnaire was designed to collect data on a variety of topics related to these issues. The questionnaire consists of four parts; 1)) EU's influence on the relationship between the firm and the specific, chosen business partner;; 2)) EU's influence on the focal business;; 3)) the relationship towards the chosen business partner, without inference from the EU, and finally;; 4)) the role of intermediaries such as politicians on local and national level as well as trade organisations. All variables were measured on a five-point ordinal scale.

The chosen setting for this study is Sweden and particularly SMEs. Following the EU definition of SMEs, e.g. firms with more than 10 and less than 50 employees, a turnover of a maximum of 10 million Euros, a sample frame was drawn from a Swedish database covering all Swedish firms. During the sampling process there were no consideration taken to the geographical dispersion of the sample unit. The questionnaire was pre-tested and some minor modifications were made to correct phrasings and ambiguous questions to exclude erroneous indicators. The data collection was done in Sweden, the late quarter of 2008 and the language was Swedish. An introductory letter was attached to the questionnaire with information about the purpose of the study, the contributions to research and the practical knowledge that it will bring to the business community. Some additional information about the sampling procedures, on how the anonymity of the respondents will be taken into consideration, how the results are going to be used and also information about how to fill in the actual questionnaire was also included. A pre paid envelope for returning the questionnaire on completion was also sent along with the self administered mail questionnaire. Finally, data from 124 SMEs were collected.

Data analysis technique

To assess construct validity and test the hypotheses, SmartPLS version 2.0M3 (Ringle, Wende and Will, 2005) were used. PLS, partial least squares are a statistical technique built on structural equation modelling and is preferably more appropriate when sample sizes are small, exploratory and/or assumptions of normal distributions are not satisfied (Chin and Newsted, 1999). The method of employing PLS for analysis follows a two-step approach. The first step comprises the assessment of the measurement model, i.e. the reliability and validity of the constructs. The second step involves specifying a structural model which is evaluated in terms of the strengths of the causal relationship.

Data analysis and results

In the analysis, the business relationship support and coercion and business performance were all operationalised as latent variables, i.e. the values of the indicators of a construct are assumed to be

caused by the latent variable and thus co-vary reflecting the level of the latent variable. The independent variable, denoted Political effect, is measured by three indicators forming a construct relating to the support from EU for business, the investment of specific resources to handle EU rules and regulation and also the level financial resources spent on political issues. The other constructs are formed in the same manner all with four indicators respectively to measure the latent variable. Business relationship support is measured through indicators on business development, taking advantage of business opportunities and the long-term development of the business relationship. Business relationship coercion is indicated by the negative effect of EU on the business relationship, the impact of rules and regulations, the difficulties in handling EU-issues and the extremity of EU-demand on the business with the business counterpart. Finally, the firm's business performance is measured by the creation of new business opportunities, the facilitation of product development, the increase of profitability and technical development. In table 1 below, all indicators of latent variables and constructs are displayed together with their mean, standard deviation, factor loading, the reliability coefficient and the average variance extracted (AVE) of latent variables.

Table 1: Means, standard deviations and factor loading for all constructs

Construct Indicator ¹	Mean	S.D.	Factor loading
<i>Business relationship support (Reliability²=0.83; AVE=0.66)</i>			
1. EU makes that we can develop our business with our business counterpart	2.21	1.17	0.80
2. Issues discussed in EU affect the development of the relationship with our business counterpart	2.64	1.15	0.73
3. We and our business counterpart have taken advantage of the opportunities created by EU	2.38	1.18	0.85
4. Long-term EU will have a positive affect on how our relationship with our business counterpart will develop	2.73	1.07	0.86
<i>Business relationship coercion (Reliability=0.87; AVE=0.72)</i>			
1. Issues discussed in EU have an negative effect on the relationship with our business counterpart	2.04	1.09	0.74
2. EU's rules and regulations has forced us to extensive changes in our business with our business counterpart	2.00	1.16	0.86
3. Handling EU-issues in the relationship with our business counterpart is troublesome	1.82	1.00	0.91
4. EU often poses preposterous demands that we have to follow in the business with our business counterpart	2.00	1.10	0.87
<i>Firm's business performance (Reliability=0.75; AVE=0.58)</i>			
1. EU has created new business opportunities	2.79	1.27	0.80
2. EU has simplified product development for us	2.22	1.05	0.81
3. EU has a positive effect on our business profitability	2.35	1.00	0.78
4. EU has a positive effect on our possibilities for technical development	2.63	1.12	0.64
<i>Political connection (Reliability=0.59; AVE=0.56)</i>			
1. We often get support from EU for our business	2.08	1.08	0.62
2. We invest specific resources for handling EU rules and regulations	1.93	1.18	0.88
3. We spent a lot money on political issues	1.70	0.98	0.72

Following the suggestions in Comrey and Lee (1992) that factor loadings of 0.71 are considered excellent, 0.63 as very good, 0.55 as good, 0.45 as fair and finally loadings below 0.32 as poor, we can state that all variables in Figure 3 above are interpreted. The reflective measurements in the model have all very good to excellent factor loadings. The individual loadings varies from 0.62, as being the smallest loading value, to 0.92 as being the largest factor loading value. The recommended value for the reliability coefficient (Cronbach's alpha) is 0.7. The value for all latent variables is exceptionally on a satisfying level and above the recommended value. The AVE is recommended that for every construct, more than 50 percent of the variance should be explained, e.g. to be higher than 0.5. In the table above, AVE is higher than 0.5 for all variables and shows that the values are satisfactory for the purposes of this analysis.

¹ Translated from Swedish original. phrasing in English may differ slightly in some cases

² Cronbach's Alpha

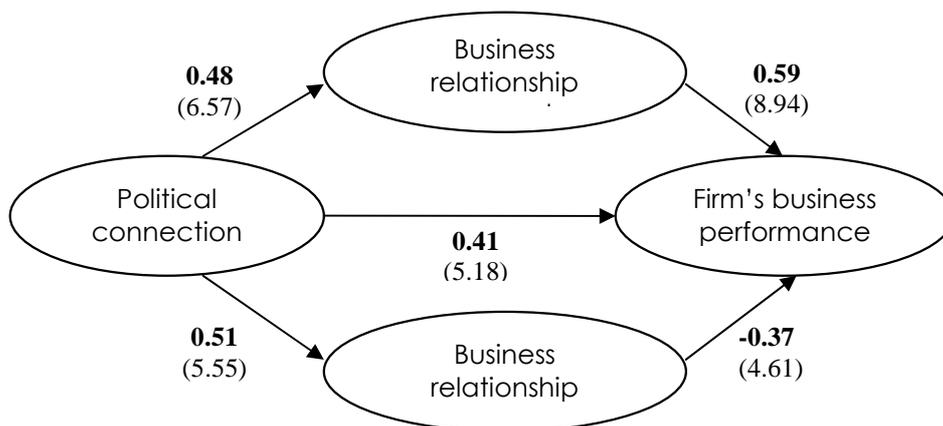
Table 2: The latent variable correlation matrix: discriminant validity –squared latent variable correlations (off-diagonal elements) versus AVE (diagonal elements)

Construct		Business relationship coercion	Business relationship support	Firm's business performance	Political connection
Business relationship coercion		0.85			
Business relationship support		0.42	0.81		
Firm's business performance	business	0.09	0.63	0.76	
Political connection		0.51	0.48	0.50	0.75

Square root of AVE on the diagonal. correlations off-diagonal

In assessing the discriminant validity among the latent variables the square-roots of the AVE of each latent variable was calculated from the PLS-output and compared to the correlations among the same variables. From the outcomes displayed in Table 2 above, it can safely be concluded that the discriminant validity is satisfactory in all cases as the square-roots of the AVE of the latent variables are larger than the correlation among them. Following this step in the analysis, a structural model encompassing the hypothesised causal relations was specified and tested in PLS. The results for the output for the analysis are displayed in Table 3 below.

Figure 3: Structural model



Note: β -coefficients with t-values in parenthesis

In figure 3 above, the output from the statistical computations of path coefficient and their statistical significance in PLS is displayed. The figure shows that all hypotheses are considered to provide adequate evidence of the predictive ability of the model and are statistically significant. The model also shows an R^2 of 54.2% for firm's business performance. Furthermore, the output shows that the

direct effect of political connection on business performance (0.41; 5.18) provide sufficient support to accept hypothesis 1; the notion that the stronger the political connection, the higher the direct impact on firm performance. The support for hypothesis 1 also validates the assumption on a link between business operations of a firm and the effect thereof of actions by political organizations. Further, the basic assumption in the study that the variety of actions by different political organizations can be aggregated into what has here been labelled the political connection and that this construction clearly has a direct and positive effect on firm performance is validated.

Turning to investigate the outcome of the statistical computations relating to the other hypotheses presented above it interesting to note that the impact of political connection on both business relationship support (0.48; 6.57) and business relationship coercion (0.51; 5.55) are statistically significant. These observations in combination provide support for hypothesis 2, *i.e.* that stronger connection the effect on business relationship support and business relationship coercion. Furthermore, when comparing the path coefficients it is evident that both the effect of political connection on business relationship support and business relationship strength is stronger compared to the direct effect of political connection on firm's business performance. This implies that the effect of political connection is more pronounced in a business relationship setting and further that the effect simultaneously provoke both supportive and coercive behaviours in the relationships.

The statistical output in Figure 3 also reveals clear support for the effect of business relationship support (0.59; 8.94) on firm's business performance. Hypothesis 3; the stronger the political connection, the higher the indirect positive effect of business relationship support on firm performance is strongly significant and thereby supported. The support for hypothesis 4 is also clear. The outcome of the analysis shows that political effect has an indirect negative effect on firm performance through business relationship coercion (-0.37; 4.61). Taken together, the support for hypotheses 2, 3 and 4 provide evidence for the indirect effect of political connection on firm's business performance, *i.e.* the mediating function of business relationship as conduits for the political connection effect on firm's business performance. Furthermore, looking at the path coefficients it can be concluded that the indirect positive effect of political connection via business relationship support (0.48 and 0.59) is higher as compared to the direct effect (0.41) of political connection on firm's business performance providing additional evidence on the importance of business relationships for the firm to gain advantage of the political connection in terms of business performance. Interestingly the mediation of the indirect effect of political connection though business relationship coercion in decreasing firm's business performance is also high, albeit lower than the other path coefficients. This implies that the true negative effects of political connection arise when the effect is stronger and mediated via the business relationship coercion. This clearly results in negative effects on the firm's business performance in despite the positive direct effects of a strong political connection.

Discussion and Conclusions

There are few academic empirical studies on the political effect on business performance. A contribution of this paper is that is that political decisions have a strong effect on business performance, weather they are supportive or coercive. Even though SMEs operate on a local market, this study has proven that the decisions made by political actors in EU effect SMEs business performance. The supportive activities made by EU have also been proven in this study to benefit the development of long-term business towards business partners and also for SMEs to take advantage of the opportunities created by EU. This paper provides some knowledge but further studies in this filed can guide researchers, business firms and also politicians. The vitality for such research is because of the importance of the SME on socio-economic systems and also the increasing voices of politicians in their supportive mission. Studying how coercive and supportive actions promote SMEs business will provide knowledge about both effects which can either create possibilities or hinders.

The results manifest the impact of political effect on business performance; no matter if the political effect is direct or indirect. The indicators for business performance were that EU creates new business opportunities, simplified product development, and has a positive effect on business profitability and possibilities for technical development. The findings reported in this paper, indicates that both direct and indirect relationships has high effects on business performance. What is more interesting is that the indirect positive effect is higher then the direct. Meaning that SMEs, similar to MNCs (Boddeweyn, 1988) cooperate with their business partners to gain further support in their business. Also for the indirect negative effect, the results reveal that the exercise for legitimate power to force business firms to follow the political decisions is rather high. The adaptive behaviour will result in higher costs and reduce the gain. However, in relation to the positive indirect effect, the negative indirect effect of business relationship coercion on business performance is lower. However, the connection between positive and negative effects on business firms are seldom researched and further studies in this can improve the understanding of political effects on businesses.

The study also has some limitations. An important one is that the measurement indicators for business performance are reflective and based on the respondents impressions and not on factual variables. A suggestion for future studies is to include turnover, number of employees etc. Another limitation in this study is that the hypotheses are measured the view of SMEs on the impact of political units. It does not concern the management behaviour of these firms to reduce the uncertainty from the impacts. Further study on how SMEs build units or cooperate with others (like studies on MNCs managerial actions towards political units) to influence political decisions can increase our understandings.

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