

How do small firms cope in the European Union?

- The importance of intermediaries and political knowledge on business performance

ABSTRACT

Small firms are embedded in a political environment. A large majority of these firms in the EU are small, and their importance for the economies (job creation, technological development and prosperity) is often highlighted by politicians and in media. The other side of the coin, i.e. EU's impact on small firms and their business relationships is, however, much less researched. There is a vast amount of organisations that function as intermediaries between small firms and the EU. The aim of this paper is, by using a theoretical network framework, to further penetrate the question of firm interaction and the special role of intermediaries for small firms' when gaining political knowledge and further, the outcome of such interaction, e.g. the perceived effect on business performance. The empirical study is based on survey data from 134 small firms in Sweden, carried out in 2008. We have in this paper developed 6 hypothesis and used PLS for statistical analysis. The results indicate that some intermediaries are more important than others and that political knowledge, specific or general, has diverse effects on business performance.

Keywords: political embeddedness, small firms, European Union, intermediaries, knowledge, business firm performance

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1. Introduction

The European business environment has changed dramatically during the last decades. There is now a single European market and political decisions that departures from the EU influence firms of all sizes. Welch and Wilkinson (2004) put forward that political organisations effect business firms and those firms are interwoven in a network containing both business and non-business actors. Business and non-business actors and units are embedded and knowledge in this context is becoming more important, both for business actors and for political actors. Playing in one market requires comprehension from both parties. Firms are dependent on politicians making decisions that are in favour for firms whilst politicians are dependent on firms to increase employment and GDP.

Firms located in Europe are presently taking part in a Europeanization process, characterized by an internationalization of public decision making, changed market conditions etc. This process has several implications, not the least for their performance. The phenomenon is discussed by Wilts & Meyer (2005, p. 176) who state that; “As the development of the European Union (EU) progresses, corporate political action is becoming more important for competitive success in Europe. The building of the Single European Market is creating new opportunities for companies to gain economic benefits through influencing political decision making.” But how do firms influence political decision making on the EU level? It is argued that “Firms that try to articulate their interests towards the EU decision-making system are faced with the management question of how to devise effective political strategies and integrate these with their market activities” (Rehbein & Schuler, 1999). Whereas large firms may allocate considerable resources to establish specialist lobbying departments and thus to interact directly with EU-organs, small sized firms have been told to be more likely to act collectively, or adapt to political decision. (Saurugger, 2001; Wilts and Meyer, 2005) Wilts & Meyer (2005, p. 178) assert, for example, that “Because of the economic importance, leading European firms are able to maintain very close contacts with high levels of the EU bureaucracy, and in many ways have become an integrated part of the EU policy network. Studies like Hadjikhani and Ghauri (2001) for example show how Swedish MNCs make commitments to influence EU-organs and their proactive behavior before political decisions are made. However, those studies rarely touch upon small firms and their embeddedness in the political environment.

No matter of firm size, political knowledge is important, e.g. knowledge about the political units, actors and decisions when trying to influence. Those firms that have successfully managed to influence a political decision will most likely relate that success to an increase in firm performance. In this study, small firms are highlighted in this process. Since resources are somewhat limited for small firms they often turn to intermediaries such as trade organizations to gain such knowledge. Several researchers claim that empirical studies of the conditions facing small firms in EU are of special importance at the present (Wilts & Meyer, 2005; Bengtson et al, 2009). Not the least so because the role of large firms in EU policy networks has been studied before (see e.g. Coen, 1999; Hadjikhani & Gauri, 2001). In studying the political conditions facing small firms in the European Union, questions of interaction between firms, and interaction between firms and other organizations that may act as intermediaries, or “collective voices”, become important. The aim of this paper is; to further penetrate the question of firm interaction and the special role of intermediaries for small firms’ when gaining political knowledge and further, the outcome of such interaction, e.g. the perceived effect on business performance.

The outline of the paper is as follows: After this section, the research model and our hypothesis are presented, followed by the methodological section. Then we move on to the data analysis and present the results of our study. Finally, we discuss our findings and make some conclusions.

2. Theoretical frame and hypothesis

This paper is based on a network approach (Håkansson & Snehota, 1995; Ford, 1998). According to Håkansson and Snehota (1995, p.4); “the network approach is especially fruitful in a world with increasing trade between countries and regions, where international companies evolve partly by acquisitions and partly by building up new units in different countries, where companies try to increase the use of suppliers worldwide and where governments get involved both as important buyers but also as promoters of specific technical areas or regions.” It is argued by these authors that building continuous relationships is a way for firms to cope with complexities and ambiguities that firms face in a market (Ibid, p. 11).

The reasoning that we put forward in this paper is rather straight forward; Political decision-making have an impact on small firms' business performance. This impact can either be positive or negative, e.g. the political actors' behavior towards business firms can be supportive or coercive. A small firm with much political knowledge has a better chance of influencing the decision-making, making it more supportive to its business, whereas a firm with less political knowledge will have smaller chances of influencing and will thus more often be faced with a coercive political impact that forces the firm to adapt, resulting in negative effects on its business performance. Hence, the ability to influence political actors regarding e.g. rules and regulations is dependent on knowledge. (Bengtson et. al., 2009)

Knowledge, however, is a broad term that needs to be defined. This paper follows a traditional epistemological route and defines knowledge as "justified true belief" (Nonaka, 1994). This definition also helps in making a distinction between information and knowledge. While information is a flow of messages, knowledge is "created and organized by the very flow of information, anchored on the commitment and beliefs of its holder." (Nonaka, 1994, p. 15; cf. Machlup, 1983) Another, often made distinction, which was first identified by Polyani (1966), is that between "explicit" and "tacit" knowledge. Explicit knowledge refers to knowledge that is transferable in formal language, whereas tacit knowledge is rooted in action, commitment and involvement in a specific context, which makes it hard to formalize and communicate. (Nonaka et. al., 1994, p. 338) By political knowledge we mean knowledge that is of use to business actors in handling the political environment of which they form part, e.g. knowledge about political decisions, about political actors involved in the decisions and about the needs and wants of connected actors on behalf of these decisions. Political knowledge is thus here interpreted as both tacit and explicit knowledge on EU matters in a rather broad sense.

According to our reasoning there is a positive correlation between the political knowledge that a firm possesses and its performance, but how then can small firms gain political knowledge? Due to limited resources small firms are restricted and are often unable to learn about the EU and to perform political activities independently. Instead knowledge on political matters is gained through various counterparts, or intermediaries in the relationship between the small firm and political actors on the EU level. An intermediating actor, or intermediary, performs according to IMP researchers (Ford, 1980; Havila, 1996) an assisting role between actors in a

relationship. This role means that they are bridging over a gap that can be geographical, cultural, physical or technical.

However, according to Nonaka (1994, p. 14) and Nonaka et. al. (1994, pp. 337-338), a problem with much contemporary organisational theory is its focus on what is given to the organisation with an over-simplistic view of the organisation as an “input-process-output” sequence of information processing. Instead they argue that one needs to consider the organisation’s *interaction* with its environment, together with its own means, in the creation of knowledge; “For example, innovation, which is a key form of organizational knowledge creation, cannot be explained sufficiently in terms of information processing or problem solving. Innovation can be better understood as a process in which the organization creates and defines problems and then actively develops new knowledge to solve them.” (Ibid, p. 337)

Based on a theoretical framing of industrial network theory (Håkansson & Snehota, 1995; Ford, 1998), and the reasoning put forward by Håkansson and Snehota (1995, p. 12) as they state that; “Much of the knowledge put in use in a company becomes available from its relationships to others outside the company. The activities of a company draw on and are made possible by some knowledge possessed by others. It becomes available in relationships to customers, suppliers and others.” We focus on small firms’ interaction with various counterparts / intermediaries as a prerequisite to reach political knowledge that impact on their business performance. In a qualitative study we conducted 2007-2008 it was indicated that there are some actors that are more important than others in assisting small firms regarding political issues. (Bengtson et. al., 2009) Trade organisations, the local municipality, national governmental bodies and business partners were conceived as intermediaries in reaching political knowledge and indirectly for performing political activities. Firms are members in trade associations for task oriented reasons, e.g. to gain direct support, and/or long term reasons, e.g. long term opinion making/representation. The local municipal and national governmental bodies can provide support and guidance to firms whereas focal business partners are important not least when handling issues that are directly related to their mutual business. The three types of counterparts that will be discussed in this paper are thus 1) interest groups such as national trade organizations, 2) political units on local and national level, and 3) focal business partners (customer or supplier). We therefore put forward our first hypotheses;

- Hypotheses 1a* *Trade organisations will increase the firm's political knowledge.*
- Hypotheses 1b* *Political units on local and national level will increase the firm's political knowledge.*
- Hypotheses 1c* *Business partners will increase the firm's political knowledge.*

Previous studies have shown that political actors and political rules and regulations have an effect on business firms and on their business relationships. (Minniti, 2008; Welch & Wilkinson, 2004) There are also studies, not least within the IMP tradition, that show that a limited number of relationships have a profound effect on company performance (e.g. Håkansson & Snehota, 1995, p. 11). Other studies still have shown that knowledge on a more general level impact positively on firm performance. (This is, for example, much discussed on industrial districts and cluster research. See e.g. Lorenzoni & Ornati, 1988). There are, however, few studies investigating the effect of political knowledge on firm performance. We have looked upon firm performance related to three aspects; development of new products, increase in revenues and, finally, positive effects on firm management.

To sum up, the impact of political knowledge about EU on firm performance is, thus, studied in relation to the three types of intermediaries connected to the firm and political bodies. We argue that these intermediaries, due to their input to the firm's political knowledge, might have an effect on the firm's business performance. In business network theory, business performance of a business unit is related to its business relationships and connections (Welch and Wilkinson, 2004; Hadjikhani and Thilenius, 2005). In this paper business performance is a perceived effect of the outcome of the business and non-business interaction rather than financial support, revenues, market shares and return on investments etc. Hence, we bring forward three additional hypotheses;

- Hypotheses 2a* *Political knowledge will positively influence business performance through trade organisations.*
- Hypotheses 2b* *Political knowledge will positively influence business performance through political units on local and national level.*
- Hypotheses 2c* *Political knowledge will positively influence business performance through business partners.*

Our theoretical reasoning and the hypotheses that we have brought forward in this section are summarized in figure 1 below, which shows how political knowledge that is gained through interaction with either one out of three types of actors, impact on business performance.

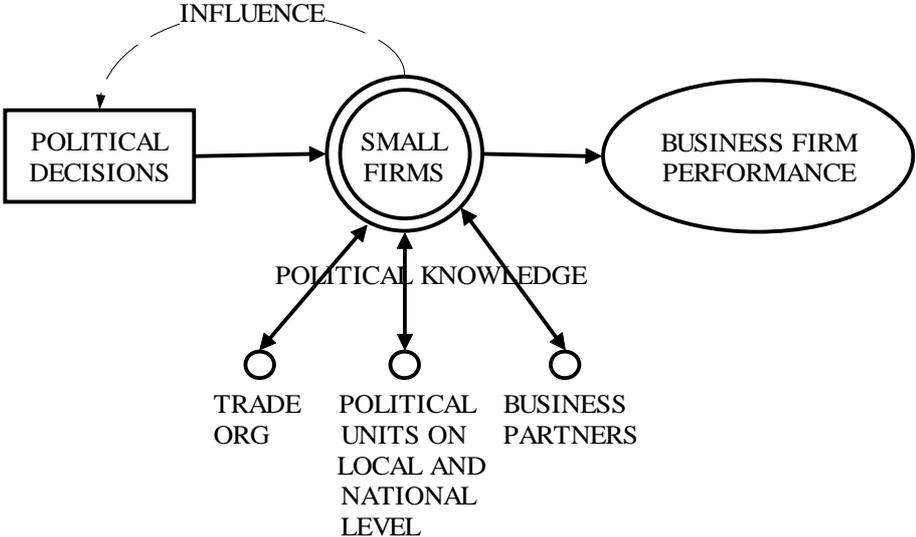


Figure 1: Theoretical model.

3. Methodology

3.1 Data

This research project is concerned with small firms in a European context, and the material for the study was collected in two ways. First, some case studies, mainly based on personal interviews, were made. These cases concerned small firms in Sweden and focused on the political embeddedness of their business. The cases were conducted in order to identify concepts and categories that were of importance to small firms in the interaction with political units, especially on the EU level. The cases laid the grounds for the next step in the research process. A questionnaire was designed to collect data on a variety of topics related to these issues. The questionnaire was developed for the purpose of evaluating the impact of EU on the firms’ core business activities, the firms’ relationships towards intermediaries such as associations, the municipal and national organisations and finally the impact on their relationship towards their business counterparts.

The chosen setting for this study is Sweden and particularly small Swedish firms. Following the EU definition of small firms, e.g. firms with more than 10 and less than 50 employees, and with a turnover of a maximum of 10 million Euros, a sample was drawn from a Swedish database covering all Swedish firms. The questionnaire was pre-tested in a face to face setting. After the pre-tests some clarifications of some sections and some minor modifications were made to correct phrasings and unclear questions to exclude erroneous indicators. Upon completion, an introductory letter was attached to the questionnaire that was sent to the sample. The letter informed 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 will be used and also information about how to fill in the actual questionnaire was included. A pre paid envelope for returning the questionnaire on completion was also sent along with the self administered mail questionnaire. Finally, data from 134 small firms were collected in late 2008 with an approximate response rate of 14 percent. However, a non response error analysis showed that there were no systematic errors amongst those that answered and those that did not. The non response error analysis covered geographical spread and branches.

3.2 Data analysis technique and operationalisation

To assess construct validity and test the hypotheses, SmartPLS version 2.0M3 (Ringle, Wende and Will, 2005) was used. PLS, partial least squares is a statistical technique built on structural equation modelling and is more appropriate when sample sizes are small, exploratory and/or assumptions of normal distributions are not satisfied (Chin and Newsted, 1999). PLS is best suited for testing complex relationships by avoiding excluded solutions and factor indeterminacy. 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.

The central and dependent variable for the study is *political knowledge*. Political knowledge is essential in both business and political contexts. In this paper we discuss specific and general political knowledge, i.e. knowledge about political decisions, about political actors involved

in the decisions and about the wants and needs of connected actors on behalf of these decisions. A political decision that derives from the EU can be a rule, regulation or directive. In this study, we have operationalised all these political decisions as *EU rules*. In the case for most small firms, the question arises of the consequences with a specific EU rule at the implementation stage of the rule, regulation or directive. Further, we assume that small firms rely on other actors, such as intermediaries. In this study, we have identified three types of intermediaries; trade associations, political units on local and national level and focal business partners. Business firm performance is in this study measured by how the effect of EU rules has increased the development of new products, increase in revenues and, finally, positive effects on firm management.

In the analysis, the three types of intermediaries 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, Political knowledge, is measured by three indicators forming a construct relating to the importance of understanding EU and the political rules, the effect of political knowledge on profitability and, the need for political knowledge. The other constructs are formed in the same manner, all with three or four indicators respectively to measure the latent variable. Trade associations are measured through indicators on their level of importance, the actual help they provide, their importance when needing information and expertise and their importance when handling the uncertainties that EU brings. The local municipal and national bodies are indicated on whether they consider firms interests on EU issues, help when applying for financial support from EU and EU problem solving. Business partners are measured through indicators on their importance when discussing EU issues, the frequency of those discussions, the solutions on EU issues solved with business partners and the support gained regarding political rules and regulations. 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.

4. Data analysis and results

The first step in the analysis comprises the assessment of the measurement model, i.e. the reliability and validity of the constructs. 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

<i>Construct</i> Indicator ¹	Mean	S.D.	Factor loading
<i>Mediating actor: Trade organisation (Reliability²=0.76; AVE=0.55)</i>			
1. Trade organisations are very important when dealing with EU issues	3.56	0.956	0.71
2. Trade organisations often help us to handle EU issues	2.74	1.419	0.81
3. We are members in trade organisations to gain information and expertise	3.66	1.275	0.57
4. It is our trade organisation (s) that help us handle the uncertainty that EU brings	2.98	1.129	0.85
<i>Mediating actor: Political units on local and nat. level (Reliability=0.69; AVE=0.62)</i>			
1. The municipality helps us apply for financial support from EU	2.12	1.089	0.67
2. Normally it is with the help of people working in the municipality that we solve problems that EU brings	1.80	0.954	0.64
3. We have good possibilities to influence people working in the municipality regarding EU issues	2.22	0.918	0.77
<i>Mediating actor: Business partner (Reliability=0.79; AVE=0.63)</i>			
1. We discuss every specific EU issue with our business partner	1.83	0.982	0.86
2. We daily discuss EU issues with our business partner	1.64	0.921	0.86
3. Together with our business partner we find solutions to EU issues	1.99	1.129	0.82
4. We often get support from our business partner regarding political rules and regulations	2.44	1.235	0.59
<i>Firms business performance (Reliability=0.80; AVE=0.62)</i>			
1. EU has created new business opportunities	2.79	1.27	0.79
2. EU has simplified product development for us	2.22	1.05	0.78
3. EU has a positive effect on our business profitability	2.35	1.00	0.75
4. EU has a positive effect on our business management and controlling	2.63	1.12	0.82
<i>Political Knowledge</i>			
1. Good understanding for EU and the rules is necessary in our business	2.79	1.14	0.92
2. Having knowledge on EU is profitable for the business	2.99	1.06	0.86
3. It is necessary to have expert knowledge when handling issues regarding political rules and regulations	3.48	1.00	0.32

Comrey and Lee (1992) recommend that factor loadings of 0.71 are considered excellent, 0.63 as very good, 0.45 as fair and finally loadings below 0.32 as poor. The reliability in the

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

² Cronbach's Alpha

measures in table 1 above, are all between 0.61 and 0.80 and thus considered as very good to excellent. Convergent validity is assessed by the AVE. The AVE is recommended that for every construct, more than 50 percent of the variance should be explained. This is standard output from PLS. The AVE reported in table 1 above, confirm that all measures demonstrate satisfactory convergent validity. Trade organisations (0.55), political units on local and national level (0.62), business partners (0.63) and firms business performance 0.62). The recommended value for the reliability coefficient (Cronbach's alpha) is 0.7. The values for all latent variables are all above the recommended value, all between 0.69 to 0.80.

In table 2 below, discriminant validity is assessed both at the item level and at the construct level.

Table 2: The latent variable correlation matrix: discriminant validity

	Business partner	Firms business performance	Political units local/national	Trade organisations
Business partner	0.79			
Firms business performance	0.48	0.79		
Local/national	0.33	0.46	0.68	
Trade organisations	0.24	0.28	0.21	0.74

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

In table 2 above, the square root of AVE for the measures on the diagonal and the correlations among the measures as the off-diagonal elements are illustrated. Discriminant validity is assessed both at the item level and at the construct level. Table X shows favourable results for the discriminant validity. Overall, the evaluation of the measurement models demonstrate that the square-roots of the AVE of the latent variables are larger than the correlation among them and thus satisfactory reliability and validity is confirmed for the purpose of this analysis.

The second step of the analysis involves specifying a structural model which is evaluated in terms of the strengths of the causal relationship. Figure 2 below presents the results of the structural model analysis.

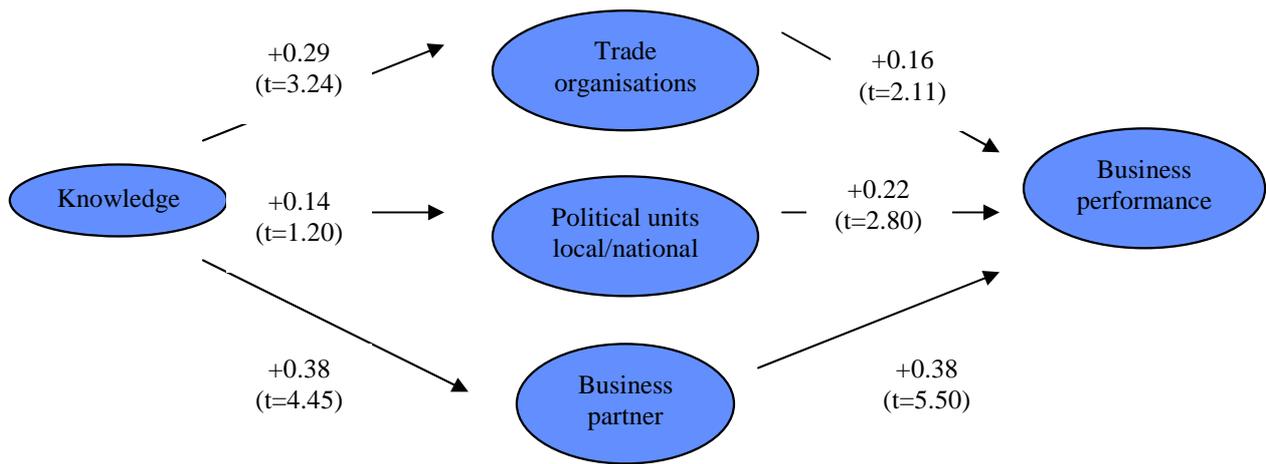


Figure 2: The structural model with measured validity for each path.

Note: β -coefficients with t-values in parenthesis

A standard bootstrapping re-sampling technique with 500 re-samples consisting of 124 cases was applied to determine the significance of each estimated path. The model shows R^2 of 31% for business performance. First, as hypothesized, that trade organisations will increase the firm's political knowledge (H1a) is moderately supported by the outcome of the analysis (0.29). Hypothesis 1b is not supported and has not a significant effect on the increase of political knowledge for firms through political units on local and national level (0.14). Hypothesis 1c is supported and firm's are thus gaining and increasing their political knowledge through business partners (0.38). Hence, it is interesting that political knowledge is rather gained from trade organisations and from business partners then from political units on local and national level.

More interestingly, the positive effect of political knowledge through the three identified intermediaries on business performance is not always those intermediaries that political knowledge is gained through. Hypothesis 2a, e.g. political knowledge will positively influence business performance through trade organisations is not supported (0.16). However, H1a showed (0.29), meaning that some form of political knowledge is gained through trade organisations. But H2a was not supported and thus meaning that the political knowledge gained has no effect on business performance. The political knowledge that was gained though, would most probably be general political knowledge rather than specific, issue based political knowledge.

The outcome of the analysis demonstrate that hypothesis 2b, political knowledge will positively influence business performance through political units on local and national level is supported (0.22). But H1b was not significant, e.g. that political units on local and national level are not important when there is a need for increasing political knowledge. Instead, political units on local and national level are more useful for small firms when applying and using different types of financial support, both those from Sweden and those that departure from EU units. That type of political knowledge has probably only concerned financial support and therefore been regarded as having an explicit positive effect on firm performance. The third hypothesis, political knowledge will positively influence business performance through business partners, is supported and the outcome of the analysis shows that it has a significant positive effect on business performance (0.38). Business partners have proven to be important in both increasing political knowledge and in influencing business performance positively. The results from the analysis e.g. the form and degree of political knowledge gained through intermediaries and their effect on business performance will be further discussed in the next section.

5. Discussion and conclusions

In this paper, firm interaction and the special role of intermediaries for small firms' when gaining political knowledge and further, the outcome of such interaction, e.g. the perceived effect on business performance has been studied. It has been argued in earlier studies that knowledge is important in firms attempt to influence political decision making (Pleitner, 1989; Bengtson et al, 2009). It has also been argued that small firms, due to limited resources, are forced to rely on its relations to others in dealing with various matters, such as the matter discussed here, i.e. political issues on EU level. Håkansson & Snehota (1995, p.6) declare, for example, that; "There are two issues, in particular, that it appear critical to the goal performance in business: how to mobilize the various different counterparts of a company and, consequently, how to develop cooperative posture and coordination mechanisms in interaction with others in order to solve problems as they arise,"

Our study shows, however, that some intermediaries, in a business and non-business environment, are more important than others. The results of our study reveal that business partners are most important when both gaining knowledge and thus provide the strongest

effect on business performance. These results are in the same line as earlier findings in IMP research. If certain suppliers account for a large portion of the firm's revenue, it seems reasonable that this supplier will also be able to support the firm in EU matters in a mode that is beneficial to the firm's performance. Earlier IMP-studies have shown that this type of mutuality is useful to both counterparts. EU matters that are important for a small firm's business performance are, more or less by definition, related to its core business, i.e. its closest business partners.

The results also revealed that trade associations only provide small firms with general knowledge. That trade organisations had no significant effect on business performance though their input to the firms' political knowledge might be the most interesting and surprising result when we compare it to the results of earlier studies. Several researchers have pointed at the need for these types of organisations in guiding especially small firms in EU policy matters (Wilts and Meyer, 2005; Cook & Barry, 1995). It is argued that small firms rely on collective forms of business action in their interaction with political actors and that they; "maintain their membership in national trade associations to acquire information about the public policy process and as a way to interact with political institutions." (Wilts and Meyer, 2005, p. 177) The difference in our result could be based on our inclusion of business performance as an indication of the usefulness of various intermediating actors. When small firms need knowledge about the political environment or specific regulatory issues they need specific knowledge. The results from our study indicate that trade associations only provide general knowledge and might not be able to interact with single small firms. As stated by Nonaka (1995), knowledge is a question of interaction and creation rather than a simple input – process – output sequence. Perhaps is the political knowledge that firms need for their business performance of a tacit nature which requires a closer interaction between the parties than the interaction that is provided between small firms and their trade associations.

An interesting result in this study is, however, that political units on the local and national level serve a purpose not only as local/national governments dealing solidly with local/national matters, but should function as an intermediating actor, i.e. translating filters, for matters on the supranational level were not those intermediaries that small firms turned to when there was a need for political knowledge. Instead, political units on the local and national level had a positive effect on business performance. This can be explained by the assumption that firms only interact with these intermediaries when gaining financial support

for their business. Hence, business performance in this study is not measured by factual numbers. Doing so would not always guarantee and show an accurate picture. There is a certain time lag and that requires a longer time perspective of the study. We used the creation of new business opportunities, the facilitation of product development, the increase of profitability and, finally positive effects on business management and control as indicators of the firm's business performance. Business performance is, however, a concept that can be measured in direct numbers. It could thus be interesting to do so, and see if the perceived performance is supported also in absolute figures for the individual firms in the investigation. It is, however, not possible to know from the figures how much of these absolute changes in performance that are correlated to an impact from the EU.

In conclusion, small firms generally do not have the resources to pursue political activities at the EU level independently. This study has shown that intermediating actors are important for small firms in handling the political impact from EU, and also that some intermediaries are more important than others. Some earlier studies have emphasised the importance of trade organisations for small firms' political knowledge when handling political issues. However, they are not as important as previously stated. In fact, our study shows that trade organisations are not important when measured against business performance and that the knowledge that was gained was general.

Our study is based on small firms in just one country, Sweden, and 134 firms have participated in our survey. It would be interesting to see how well the results hold in another context. Does, for example, British or French firms function similarly, or are there any statistically significant differences in how small firms use intermediaries on EU matters? We believe that there is enough international research on relationships between various business firms to guess that they are important also on these matters in other countries, but are less certain about the impact from the other two types of actors in another national context.

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