ECONOMIC VS. MANAGERIAL PERSPECTIVES ON FIRM PERFORMANCE

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Abstract

Classical economic theory has historically downplayed discretionary differences between firms [1]. Firms face given and known choice sets – the production possibilities frontier. What a firm does, and how well it performs, are determined by the conditions they face and, possibly, by certain unique attributes they possess. Any subsequent differences in firms are ultimately attributable to differences in initial conditions, or to the luck of the draw.

In business management and strategy, discretionary firm differences are central to the evaluation of individual firm performance. Managerial choice is considered an important determinate of what a firm does and its subsequent performance. This paper attempts to compare and contrast the two perspectives in the examination of small firm performance.

1. Theoretical Background

The classic economic perspective is that firms face given and known choice sets [1] — the production possibilities frontier — and that a firm's behavior is determined by the initial conditions it faces and its unique attributes. As such, there is little support for the proposition that discretionary firm differences matter. The "reasons for firm differences, in technology or organization, are ultimately driven back to differences in initial conditions, or to the luck of the draw, which may make choice sets different" [1, p. 65]. Such a perspective is not surprising as the primary focus of economists is industry or economy wide performance.

Moving away from a classical economic perspective, Porter [2] believes that environmental influences are very important, but that there is a considerable range of freedom as to how individual firms will, or will not, respond to threats and opportunities in the environment.

While the notion that distinctive competencies could lead to a competitive advantage would appear to be self evident, This has not always been the case. As noted above, the field of economics has only recently allowed that managerial choice can lead to individual differences between firms and that such differences can make a difference in firm performance. The field of Management, on the other hand, has long recognized the importance of managerial choice and has sought to identify distinctive competencies, which might affect firm performance.

The expectation is that successful firms will have certain abilities or resources, which will allow them to perform at a superior level, relative to their competition. Such "distinctive competencies" are the skills, abilities or major resource strengths that distinguish the organization from its competitors or rivals [3, 4]. If these distinctive competencies are valuable and difficult to imitate, they will give the firm a competitive advantage and allow it to gain a superior market position.

Most of the early research on distinctive competencies used relatively simple nominal and single item scales to measure the relative strength of an organization's functional activities [5, 6]. More refined multi-item instruments were subsequently developed to provide higher levels of discriminatory power and lower levels of measurement error of the distinctive competency construct. Hitt and Ireland [7] developed an instrument that measured 55 distinctive competency activities and their performance relationship in large, industrial firms. Other studies have included Conant, Mokwa and Varadarajan [8] (20 item instrument using large HMOs), Acar [9] (a 14 item instrument using small Turkish casting and machinery manufacturing firms), Droge, Vickery, and Markland [10] (31 item instrument using large furniture manufacturing firms), Chandler and Hanks [11] (19 item instrument using industrial firms), and Conant, Smart and Solano-Mendez [12] (small, specialty apparel retailers0.

McGee and Finney [13] used a modified version of the instrument developed by Conant et al. [12] to measure distinctive competency and competitive advantage among a cross section of 189 small, rural Midwestern retailers. Factor analysis of 23 individual distinctive competency items found five areas of distinctive competency. They were; quality image, effective differentiation, effectiveness of key merchandising practices, civic involvement, and control of retail program. The authors found that all five competencies influenced a number of performance variables and suggested that they did serve as viable sources of competitive advantage for small retailers.

McGee and Peterson [14] further developed the instrument developed by McGee and Finney [13] and identified three three-item measures for the construct of distinctive competency for small independent retail pharmacies. The nine item measurements represented three distinctive marketing. Service image was comprised of three items related to the image of quality service — quality of customer service, handling of customer complaints, and store image. Control of retailing consisted of three items related to controlling costs and effective pricing strategies — effectiveness of pricing strategies, effectiveness of cost containment, and control and evaluation of retail program. Action ability consisted of three items related to store strengths and employee training — putting plans into action, awareness of store strengths, and employee training.

Rogers, et al [15] in their study of inner city small business owners, identified owners knowledge (educational level), skills (whether or not they had a business plan), access to capital (whether or not they had a bank term loan, line of credit, or commercial mortgage) and the ethnicity of the ownership as the most critical factors leading to the growth and viability of the firms. Access to capital and ethnicity were found to be significant shift parameters for the production possibilities frontier.

This study assumed a economic perspective and its findings are consistent with classical economic theory as described above. Differences in firm performance were "ultimately driven back to differences in initial conditions" [1, pg. 65]. Ethnicity, the ability to get a loan, and educational background, are not generally considered discretionary managerial choices. What the Rogers, et al [15] study does not address are the effects that discretionary choices have on firm performance. Does discretionary managerial choice make a difference, or are managerial choices overwhelmed by industry conditions? Students of business management and strategy would like to think management choice affects firm performance, yet traditional economic theory is largely silent on this.

2. Research Design and Methodology

As part of an Urban Studies Grant, an update of the Rogers, et al [15] survey was conducted. This provided a unique opportunity to simultaneously survey the sample firms from both an economic and a managerial perspective.

Questions aimed at identifying distinctive competencies were derived from McGee and Peterson [14] and were added to the survey. Distinctive competencies are the skills, abilities or major resource strengths that distinguish the organization from its competitors. If these distinctive competencies are valuable and difficult to imitate, they will give the firm a competitive advantage and allow it to gain a superior market position.

Approximately 1,100 surveys went out to small businesses in three inner city neighborhoods in Buffalo, New York. There were 182 complete surveys returned.

3. Data Analysis

First, a replication of the Rogers et al [15] data analysis was made. Sales was used as a measure of firm performance. Sales data was obtained from Microcosm, published by Dunn & Bradstreet. This reduced the sample size to a maximum of 82 firms for the empirical estimation of the regression models. As in Rogers et al [15], this did not materially affect the main characteristics of the data.

The empirical specifications of the model were based on the natural log of sales. Societal issues (0,1) — gender, ethnicity and owner's education — were indicator variables (with minorities and women coded 1). Business issues (0,1) included existence of a business plan, family ownership, and the presence of existing loans. Hours worked by owners (a measure of effort and commitment) was expressed as a natural log. Finally, industry identifiers were included, with coefficients measured relative to the omitted industry — Personal and Food Services.

The following equation was estimated:

ln(Sales) = 9.832 + .558 (Business Plan) + .171 (Owner's Education) + .554 (Exisitng Loans) + .333 (Family Business) + .298 ln(Hours Worked Per Week) – 1.010 (Minority-owned) - .464 (Women Owned) + 1.025 (Retail/Wholesale Trade) + .813 (Business Services) + .562 (Construction/Trades) + 1.264 (Manufacturing)

Based on t-statistics, the most significant variables that explain sales are (1) having a formal business plan, (2) a higher level of education, (3) access to capital, and (4) ethnicity. Controlling for other factors, including industry, a business plan adds 55.8% to sales, access to capital adds 55.4%, and white owned firms tend to have sales which are 101% higher than minority owned firms. Each level of change in education adds 17.1% to sales.

Next, a production model was developed, which resulted in the following model:

ln(Sales) = 10.165 + .987 ln(Employees) - .384 (Minority-Owned) + .374 (Existing Loans) + 1.313 (Retail/Wholesale Trade) + 1.056 (Business Services) + .695 (Construction/Trades) + .843 (Manufacturing)

These results were consistent with Rogers et al [15].

Distinctive competencies were measured on thirteen items using a seven point Likert-type scale. For data analysis, this was converted to a three point ordinal scale with 1 and 2 (much worse or worse than average) –1; 3, 4 and 5 (slightly below to slightly above average) 0; and 6 and 7 (above to much better than average) 1.

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