

**Do Institutions Matter to the Strategic Posture and
Performance of SMEs?
Lessons from an Emerging Economy**

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Abstract

Can the institutional environment explain why some SMEs are more entrepreneurial and better performers than others? This study seeks answers to this question by developing and testing measurement and structural models of formal institutions as they relate to the strategic posture and organisational performance of small and medium enterprises (SMEs) in an emerging economy context. Guided by institutional theory, the study proposes a set of formal institutions which reflects the SMEs' institutional environment at the sub-national or city-level as opposed to the more common institutional analyses with country-wide focus.

The study involves a survey of 955 owners and/or managers of SMEs in two cities in the Philippines. The study attempts to determine the owners'/managers' perceptions on how the formal institutional environment impacts their firms' overall entrepreneurial strategic posture, and consequently, the firms' overall organisational performance. The empirical analysis makes use of structural equation modelling (SEM) to examine the measurement and structural models to test the hypothesised relationships in the institutions-strategic posture-organisational performance nexus.

The study's results show that four types of formal institutions are significantly associated with an entrepreneurial strategic posture and that the latter is positively associated with higher levels of organisational performance. Our analysis also demonstrates the partial mediating role of strategic posture in the majority of the formal institutions - organisational performance relationships. Implications of the results and future research directions are discussed with strong emphasis on the lessons that may be applicable to small firms or SMEs in developed economies like Australia and New Zealand.

Introduction

Institutional theory suggests that institutions can explain economic performance in general, and firm behaviour and performance, in particular (North, 1990, 2005). Whilst the proposition that institutions matter has almost become a cliché in the literature, the current research gap dwells on the need for an in-depth understanding on *how* institutions matter and in *what* context do various forms of institutions matter (Bowen & De Clercq, 2008; Manolova, Eunni & Gyoshev, 2008; Peng, Wang & Jiang, 2008). This is the main research gap that we attempt to address by proposing and testing a model of institutions operating at the city-level in an emerging economy context and the impacts these institutions have on the strategic posture

and performance of SMEs domestic firms operating within the locality. The study focuses on the formal or ‘written’ institutions as opposed to informal institutions or unwritten codes of conduct both of which comprise North’s (2005) typology of institutions.

One specific current research gap that we hope to address is the need to understand the institutions – strategy – performance nexus in the context of emerging economies (Ando, 2007; Bruton, Ahlstrom & Obloj, 2008). The unique institutional characteristics of emerging economies which subsume in-transition and developing countries prevent auto-application of developed country-orientated, mainstream theories in strategy research (Hoskisson, Eden, Lau & Wright, 2000; Wright, Filatotchev, Hoskisson & Peng, 2005). The institutions – organisational strategy interface that is considered trivial in a developed country-setting may be crucial when studied in the context of emerging economies (Demirbag, Tatoglu & Glaister, 2008).

Leading scholars like Peng et al (2008) among others, suggested that there is so much to know as to how institutions influence the strategic choices and performance of firms, be they foreign or domestic, in an emerging economy set-up. This could be attributed to the fact, Peng et al (2008) contend, that conventional research on the environment – strategy – performance linkage has been dominated by the research-based view (Barney, 1991) and the industrial organisation (I/O) paradigm (Porter, 1980). This task-environment orientated-research on organisational strategy caused the relegation of the wider institutional environment as mere ‘background of the study’.

Furthermore, as conventional institutional analysis has been repeatedly applied in country-wide settings, a growing interest is on understanding the institutional framework at the sub-national levels such as a state, region or city (Brouthers, 2002; Busenitz, Gomez & Spencer, 2000; Meyer & Nguyen, 2005). The argument is that whilst national institutions do matter, it is important to recognise that there are may be institutional divergence between and amongst sub-national geo-economic and political areas within the same national boundary (Ando, 2007; Narayanan & Fahey, 2005). This is especially true in countries with diverse multicultural identifications that are situated in dispersed geographic locations such as the Philippines (Meyer & Nguyen, 2005).

Given these research gaps, we attempt to achieve three main objectives using structural equation modelling (SEM) technique. First, we propose a measurement model of formal institutions that fairly capture the city-level formal institutional environment in an emerging economy context. The typology of formal institutions was derived mainly from studies on governance quality and entrepreneurial environment (Busenitz et al., 2000; Fogel, Hawk, Morck & Yeung, 2006; Kaufmann, Kraay & Mastruzzi, 2006).

Second, we conduct an empirical study to examine the influence of formal institutions on the strategic posture of small and medium enterprises (SME) in two cities in the Philippines as well as the consequent influence of strategic posture on firm performance. Finally, we explore the mediating role of strategic posture in the formal institutions – organisational performance linkages. The mediation analysis is aimed at gathering empirical support on the view that institutions can explain the organisational performance of firms through their impact on the firms' strategic posture.

Apart from North's (1990) institutional theory, the study draws theoretical support from theories of strategic choice (Beckert, 1999), organisational adaptation (Hrebiniak & Joyce, 1985), and resource dependency theory (Pfeffer & Salancik, 1978) to explain the formal institutions – strategic posture - organisation performance linkages.

The paper starts with a theoretical and conceptual discussion of North's (1990) institutional theory, the nature of formal institutions, strategic posture and the importance of SMEs. Next, the conceptual model of the study is discussed highlighting the relationships between a set of formal institutions and SME strategic posture. Likewise, the relationship between strategic posture and organisational performance is also discussed. The paper then presents an empirical study of SMEs in two cities in the Philippines. Finally, the paper presents the results as well as the conclusions and implications for further research.

New Institutional Theory

The seminal work of Douglas North in the field of new institutional economics (North, 1992) has inspired numerous studies on institutional theory. North (1992) broadly defines institutions as the “rules of the game” or humanly devised structures that provide incentives and constraints to economic players. It suggests that these economic players are embedded in an external environment characterised by high degree of uncertainty and transaction costs (Baum & Oliver, 1992; Hollingsworth, 2002). The presence of economic uncertainty makes it costly for SMEs to transact. Institutions are formed to reduce this uncertainty by setting the “rules of the game” in the form of formal rules, informal norms, and their enforcement characteristics (North, 1992, 2005).

These institutions are generically classified as a continuum with formal institutions in one end, and informal institutions in the other. The degree of formality lies in the articulation of these institutions and their corresponding enforcement mechanisms (Hodgson, 2006; North, 1990). Formal institutions refer to the legal and political structures and processes in the city that explicitly specify and enforce the rights, duties, responsibilities and privileges of its local populace including business entities and govern the interrelationships amongst them (Aidis, 2005; Busenitz et al., 2000; Fogel et al., 2006; Nkya, 2003; Peters, 1999; Prasad, 2003). These formal institutions are articulated in written forms, administered by a central authority, and violations of these “rules” entail legal sanctions (Redmond, 2005).

On the other hand, informal institutions refer to unwritten codes of conduct, norms of behaviour, unwritten rules, conventions, and generally accepted ways of thinking that come from socially transmitted information and are part of the heritage that we call *culture* (North, 2005). This study focuses on formal institutions only.

Strategic Posture of Firms

No business organisation would survive in the long run in the absence of a strategy (Thomson, 2001). Hence, the exercise of strategic choice is a fundamental managerial and organisational function in every SME. Strategic choice refers to the *determination of courses of strategic action an organisation should take* (Child, 1997). The exercise of strategic choice by SMEs is operationalised by the concept called strategic posture (Covin & Slevin, 1989). Strategic posture or the top management’s risk taking behaviour with regard to investment decisions and strategic actions in the face of uncertainty, the extensiveness and frequency of product innovations and the related tendency toward technological leadership, and the pioneering nature of the firm as evident in the firm’s propensity to compete with industry rivals aggressively and proactively (Covin & Slevin, 1990; Covin, Slevin & Schultz, 1994; Gibbons & O'Connor, 2005).

Strategic posture implies that a firm can be categorised along a continuum ranging from less entrepreneurial to more entrepreneurial (Covin, 1991; Covin & Slevin, 1990). Strategic posture, whilst exercised by the owner of an SME, or top management of a firm, is considered an organisational variable as organisations are reflections of the values and cognitive bases of powerful actors (Carpenter & Fredrickson, 2001). Strategic posture, hinges on three fundamental constructs: innovativeness, proactiveness, and risk-taking. Innovativeness reflects a tendency to support new ideas, novelty, experimentation, and creative processes, thereby departing from established practices and technologies (Lumpkin & Dess, 1996). Proactiveness refers to a posture of anticipating and acting on future wants and needs in the marketplace, thereby creating a first-mover advantage vis-à-vis competitors (Lumpkin & Dess, 1996). Risk-taking is associated with a willingness to commit large amounts of resources to projects where the cost of failure may be high (Miller & Friesen, 1982).

Small and Medium Enterprises (SMEs)

The role of small and medium enterprises (SMEs) in economic development cannot be overemphasized. Comprising over 98% of total enterprises in Asia-Pacific (APEC 2002), SMEs have assumed a leading role in economic development of many countries (Benney, 2000; Lee & Peterson, 2000; OECD, 2005). For instance, in the Philippines, 99.6% of the total 810,362 business establishments as of 2003 are micro (91.75%), small (7.5%) and medium (0.35%) firms generating 67.9% of the country's total employment (DTI, 2005).

However, the liability of smallness that is inherent amongst these SMEs explains that despite their potential to contribute to economic growth, they are unable to compete well due to exogenous and endogenous constraints (Kirby & Watson, 2003; Lall, 2000). Institutional analysis has been used in a variety of ways to diagnose and offer remedies to the functional, performance, and competitiveness issues associated with SMEs (Basu, 1998; Busenitz et al., 2000; Carlsson, 2002; Carney & Gedajlovic, 2002; Manolova et al., 2008).

The Research Model and Hypotheses

The research model of this study argues that the various types of formal and informal institutions (identified in the following sections) are antecedents of SME strategic posture, which in turn, is an antecedent of SME organisational performance. Figure 1 shows these links. City location is treated as a control variable to account for variations between the two cities that were covered in the study (Becker, 2005).

[Inset Figure 1. The Conceptual Framework]

Identification of formal institutions is mainly based on the seminal work of Kaufmann et al (2006) on governance and institutional quality which inspired more studies on the role of formal institutions in economic development. Five formal institutions were initially identified in the study, namely: rule of law, protection of property rights, regulatory quality, and government assistance.

Theoretical Bases of the Formal Institutions – Strategic Posture Link

The reduction, if not elimination, of transaction costs and uncertainty in market exchanges is the basic tenet of institutional theory (North, 1990). Formal institutions, such as rule of law, regulatory quality, and government policies support the full-functioning of a market economy whereby no economic player enjoys undue privileges nor disadvantages (Meyer, 2001). Studies have shown that entrepreneurial undertakings thrive in such institutional environment (Manolova et al., 2008; Nkya, 2003; North, 2005). For instance, the theory of opportunity exploitation (Shane, 2003) suggests that formal institutions reduce information asymmetries and encourage free exchange of information which facilitates the exploitation of

entrepreneurial opportunities. In effect, firms are likely to pursue an entrepreneurial strategic posture if the formal institutions in the wider environment create a level playing field for efficient market exchanges where rights and duly-earned privileges held by firms are secured and protected (Vatn, 2005).

The theory of organisational adaptation (Hrebiniak & Joyce, 1985) on the other hand, suggests that the formal institutional environment influences firm's decision-making by signalling which strategic posture and choices are acceptable. As a result, firms exercise their strategic posture as a matter of response or adaptation to the pressures exerted by these formal institutions. Extending this view is the theory of environmental management (Zeithaml & Zeithaml, 1984) which suggests that firms are not necessarily passive recipients of environmental endowments but proactive entities that are able to pursue an entrepreneurial strategic posture that can circumvent or boldly alter the formal institutional environmental constraints and conditions.

North's (1990) views on the role of institutions are also consistent with the theories of resource dependency (Pfeffer & Salancik, 1978) and environmental munificence (Castrogiovanni, 1991). These two classic theories suggest that firms depend on the level of munificence of the external environment in order to procure the kind of resources that are essential to pursue an entrepreneurial strategic posture. The formal institutional environment may be the direct source of resources (e.g. government assistance) or may open up avenues (e.g. through clear cut policies) through which firms can engage in market exchanges and entrepreneurial undertakings knowing that rights and privileges are well-protected and strictly-enforced (e.g. protection of property rights and rule of law). The presence of supportive institutions reflects environmental munificence which has been shown to be positively associated with a range of strategic choices and organisational options (Anderson & Tushman, 2001; Jogaratnam, Tse & Olsen, 1999).

Hypothesis Development

This section presents a brief discussion of the five formal institutions, followed by the presentation of the hypotheses that will be empirically tested in this study.

Rule of Law. Rule of law refers to the supremacy of law whereby decisions are made by the application of known principles or laws without the intervention of discretion in their application (Kahn, 2006). A place with a strong rule of law is defined as one having sound political institutions, a strong court system, and provisions for orderly succession of power as well as citizens who are willing to accept the established institutions and to make and implement laws and adjudicate disputes (Oxley & Yeung, 2001). Fogel et al (2006) highlight the importance of transactional trust in entrepreneurial activities such as innovation, risk-taking and opportunity exploitation. Referring to the degree of trust parties to a business transaction place on each other, transactional trust is enhanced if there is strong adherence to the rule of law characterised by effective legal and judicial systems. Through adherence to rule of law, parties to a transaction have the confidence that they are protected from

opportunistic behaviour such as cheating and illegal deviations from agreed terms as they enter into economic exchanges. Increased transactional trust therefore allows SMEs to be more aggressive in seeking for opportunities, building alliances, bearing risks, raising capital and entering markets (Fogel et al., 2006). Hence, it is hypothesised in this study that:

H₁ - Rule of law is positively associated with entrepreneurial strategic posture.

Protection of Property Rights. Possession of significant assets cannot be efficiently used to increase output and promote business growth if such assets lack the legal status of property. Protection of property rights include the protection and enforcement of right to use, exclude others from using, modify, obtain income from, and sell assets (Landau, 2003; Reed, 2001). These rights allow the owner to enjoy a benefit stream that is only as secure as the duty of all others to respect the conditions that protect that stream (Prasad, 2003). Firms are unlikely to be highly motivated to take the risks of investing in innovative undertakings if their rights, private property and the fruits of their innovative labour are not adequately protected by law (Norton, 1998). Hence, it is hypothesised in this study that:

H₂ - Protection of property rights is positively associated with entrepreneurial strategic posture.

Government Policies. Government policies refer to the locally enacted and implemented laws, ordinances, regulations and any other forms of legislations and/or government decisions especially those that affect the business sector (Fogel, 2001). Government policies form part of the overall regulatory component of the institutional framework of a country, region or city which promote certain types of behaviours and restrict others (Parboteeah et al., 2008). These policies make market activities more predictable and lower the cost of searching for information as well as enforcement of rights and contracts. Government policies may be viewed as conduits through which SMEs can engage in business activities consistent with external rules and regulations, hence, reducing the level of uncertainty (e.g. fear from government intervention). Hence, it is hypothesised in this study that:

H₃ – Government policies perceived as conducive for SME business are positively associated with entrepreneurial strategic posture.

Regulatory Quality. Regulatory quality refers to the degree to which compliance of the existing laws, rules, and other government regulatory procedures does not impose unreasonable burden on SMEs (Fogel & Zapalska, 2001; Geiger & Hoffman, 1998; Gnyawali & Fogel, 1994). Bureaucratic inefficiencies increase the unnecessary costs incurred by businesses in government-business exchanges. These costs include direct financial costs as well as the time and effort spent for the completion of these transactions. The tedious and long-winding bureaucratic processes could take away precious time from the productive activities of small businesses (Verheul, Wennekers, Audretsch & Thurik, 2002). SME's entrepreneurial strategic posture can be well supported by the local government through the quality of its regulatory system that does not impose burdensome financial (e.g. excessive fees) and non-financial (e.g. time and effort) costs on SME as they try to satisfy the legal requirements for business operation

H₄ – Regulatory quality is positively associated with entrepreneurial strategic posture.

Government Assistance. Government assistance is expressed as the extent to which the local government extends various forms of assistance or incentives supportive of the SME sector (Busenitz et al., 2000). The government may design specific programs that provide small businesses access to needed resources or reduce the risks for starting or expanding the business (Busenitz et al., 2000). Previous studies have shown the positive effects of government assistance on the entrepreneurial endeavours of SMEs in many developing countries (Arinaitwe, 2006). Government assistance is also considered as incentives in the truest sense of the word. Incentives, in the Northian institutional context, refer to a set of institutional factors that encourages or supports specific behaviours or activities (in this case, entrepreneurial activities). As North (1990) puts it, formal institutions have two fundamental functions: to discourage unproductive behaviour through the use of rules; and to promote productive behaviour through the use of incentives. Hence, it is advanced in this study that:

H₅- Government assistance is positively associated with entrepreneurial strategic posture.

Strategic Posture and Organisational Performance

The study advances the view that strategic posture reflects the managerial choices in the form of strategies which ultimately determine the performance outcomes of firms (Priem, 1994; Venkatraman & Prescott, 1990). The argument emanating from the industrial organisation literature highlights the structure-conduct-performance link suggesting that conduct (i.e. strategic posture) is an antecedent of firm performance (Porter 1980; Swamidaas and Newell 1987; Hitt, Ireland and Hoskisson 2007). Similarly, the strategy-coalignment principle (Venkatraman & Prescott, 1990) posits that the firm's strategies, if properly suited to the firm's external environmental and organisational context, have significant positive implications for firm performance (Bayo-Moriones & Merino-Diaz de Cerio, 2002; Cavusgil & Zou, 1994). Strategies are the mechanisms through which the firm manages its relationships with the external environment and serve as the basic driving force in the value-creating processes of the firm in all functional areas of the business (Swamidaas & Newell, 1987). This creation of value is manifested in the firm's organisational performance. Several studies have cited the positive effects of an entrepreneurial strategic posture on various facets of organisational performance (Covin & Miles, 1999; Wiklund, 1999; Wiklund & Sheperd, 2005). Hence, it is further hypothesised in this study that:

H₆ - An entrepreneurial strategic posture is positively associated with organisational performance.

Mediating Role of Strategic Posture

The study posits that strategic posture is the firm's unique way of responding to its formal institutional environment. Consequently, this response will determine the firms' overall performance. Hence, it can be surmised that the formal institutions can only influence the firm's overall organisational performance by way of exerting pressures on the firm's strategic posture. Hence it is further hypothesised in this study that:

H₇ - Strategic posture mediates the formal institutions – organisational performance relationships.

Research Methodology

Sample and Study Setting

The survey retrieved 955 (68.21%) out of the 1,400 questionnaires distributed in two cities in the south-eastern region of the Philippines. To account for possible variations in formal institutions due to amount of resources held by the city government units, the two cities were chosen on the basis of their income classification. Hence one city was chosen being a first class (high income) city, whilst the other was identified as a fourth class (low income) city (NSCB 2007).

The unit of analysis was at the firm or enterprise level because the study involved knowing how the wider institutional environment relates to two organisational-level phenomena: strategic posture and organisational performance. However, the actual survey respondents were owners/managers of SMEs duly registered with their respective city governments based on the argument that firm behaviour and performance are mere reflections of the strategic choices of the firms' top management (Anderson & Paine, 1975; Hambrick & Mason, 1984). Out of the total retrieved questionnaires, 900 (64.29%) constituted the overall usable response rate. Of the 900 responses, 271 were manufacturing firms (267 small and 4 medium enterprises) and 629 were service firms (excluding trading firms) (627 small and 2 medium sized firms).

In terms of city location, 454 firms (161 manufacturing firms and 293 service firms) were from city A and 446 (110 manufacturing firms and 336 service firms) were from city B. Whilst the average age of the sample firms was 6.33 years (SD = 5.83) with the youngest being 1 month old, whilst the oldest firm was 40 years old, 85% of the sample firms were less than 10 years old. Moreover, 107 firms reported only one employee, 224 firms reported two employees and 160 firms reported only three employees. Firms with less than four employees accounted for 55% of the total sample. The high response rate could be attributed to the use of enumerators who distributed and retrieve the questionnaires as opposed to using postal service. The size classification of firms was based on the number of full-time staff whereby small firms are those with less than 100 employees whilst medium-sized firms are those with 100 to 199 employees (SMED, 2003).

Wave analysis did not reveal any non-response bias (Lankford, Buxton, Hetzler & Little, 1995; Rogelberg & Stanton, 2007). Results of the Harman's single factor test as well as partial correlation analysis using a marker variable suggested that mono-method bias was not a concern in the study (Hair, Black, Babin, Anderson & Tatham, 2006). Using SPSS v. 14, missing values analysis was performed and subsequently, mean substitution was applied due to the missing completely at random (MCAR) nature of the values. The distribution of data was considered within the normal range with respect to skewness and kurtosis indices.

Measurement

The indicators used to measure the formal institutions were adapted from previous studies on institutional and governance quality (Frye & Zhuravskaya, 2000; IMD, 2006; La Porta, Lopez-de-Silanes, Shleifer & Vishny, 1999; World Bank, 2002), business climate and national competitiveness (IFC, 2007; Lopez-Claros, Altinger, Blanke, Drzeniek & Mia, 2007), and institutional environment (Busenitz et al., 2000; Fogel et al., 2006). The items elicited the extent of agreement or disagreement (in a seven –point Likert scale) of the respondents on the items describing the five formal institutions. Rule of law was comprised of six items (e.g. *In this city, the judicial system is fair and impartial*). Protection of property rights was comprised of four items (e.g. *In this city, the local government enforces laws that protect private property*). Government policies were measured by five items (e.g. *In this city, the policy direction of the local government is clear and consistent*). Regulatory quality was comprised of eight items (e.g. *In this city, the time required to register a business is reasonable.*). Government assistance was comprised of five items (e.g. *In this city, the local government sets aside government contracts for local new and small businesses*).

The perceptual measurement of these formal institutions was consistent with the concept of “perceived and enacted environment” which suggests that it is the firm owners’/managers’ perception of the environmental elements that matter in organisational strategic processes (Bourgeois, 1980; Oswald, Mossholder & Harris, 1997; Weick, 1988).

Strategic posture was composed of nine items adopted from Covin’s and Slevin’s (1989) work whereby responses to statements (e.g. *in dealing with my competitors, my business typically responds to actions which competitors initiate or typically initiate actions to which competitors respond*) were expressed in a seven-point scale with 7 reflecting an entrepreneurial strategic posture and 1 reflecting a less entrepreneurial (i.e. conservative) strategic posture. Organisational performance, on the other hand was measured by four items dealing with sales, net income, market share and return on investment (ROI). These four indicators had been shown to be adequate performance measures and had been consequently used in previous studies (Baker & Sinkula, 2005; Rowe & Morrow, 1999; Venkatraman & Ramanujam, 1986; Westhead & Howorth, 2006).

Respondents were asked to rate the *level of importance* they attached to each of the performance indicators. They were subsequently asked to express their perception on their *level of performance* on these indicators relative to their competitors in the last three years. The importance scores were multiplied by the perceived performance scores to generate the weighted performance scores for each of the four performance indicators. This approach was consistent with previous studies that dealt with firm performance (Delaney & Huselid, 1996; Naman & Slevin, 1993). Perceptual measures of performance have been shown to be valid, reliable and therefore have acceptable level of utility for empirical research (Dess & Robinson, 1984).

Data Analysis

Structural equation modelling (SEM) was used to test the hypotheses of the study aided by the software called EQS 6.1 (Bentler, 1995). SEM is a multivariate statistical technique to confirm the causal relationships of latent variables in a model strongly guided by theory. Using Anderson's and Gerbing's (1988) two step approach, this study developed and confirmed an effective measurement model using confirmatory factor analysis. Subsequently, the study analysed the structural model depicting the hypothesised relationships of the constructs.

Confirmatory factor analyses (CFA) was performed on the five formal institutions, strategic posture and organisational performance using maximum likelihood technique (Brown, 2006). CFA is a tool that seeks to determine if the number of factors and the loadings of measured indicators or variables on the factors conform to what is expected on the basis of pre-established theory (Mueller, 1996; Thomson, 2004). The indicators or items were pre-selected or assumed to load to a specific factor or construct based on prior strong theoretical, conceptual or empirical evidence (Brown, 2006; Hair et al., 2006). Details of the CFA are shown in Table 1.

[Insert Table 1. The Measurement Model here]

Initial results of the CFA on formal institutions required re-specification of the measurement model aided by the modification index called Lagrange Multiplier (LM) and Wald tests provided by EQS (Bentler, 1995). Results of the LM and Wald tests indicated that a significant improvement in the goodness-of-fit measures could be gained as shown in model B shown in Table 2, by dropping two items (with factor loadings below .5) measuring protection of property rights and combining the remaining items with that of rule of law. All the combined items were subsequently subsumed under the factor, called rule of law. Previous studies had shown the very close and substantive theoretical linkage between rule of law and protection of property rights (Frye & Zhuravskaya, 2000; Reed, 2001). Model modification is warranted if there is substantial theoretical basis to do so (Byrne, 2006). Further details are shown in Table 2.

[Insert Table 2. Goodness-of-Fit Measures here]

The CFA results further showed that all of the items measuring each of the four formal institutions, strategic posture and organisational performance loaded highly on the pre-determined factors with no path estimate lesser than the .5 minimum value (Brown, 2006). All constructs showed acceptable level of reliability as evidenced by the high internal consistency coefficients (i.e. Cronbach α) ranging from .76 (organisational performance) to .97 (regulatory quality). Itemised analysis revealed that the composite internal consistency of each factor would not improve if a component-item was deleted.

Convergent validity was indicated by the fact that the items loaded significantly (i.e. $t > 1.96$) on their corresponding construct with the lowest t -value being 14.57 (Bagozzi, Yi & Phillips, 1991). In determining the discriminant validity of the constructs, the correlations among the latent constructs were examined to check if the values were significantly less than one.

Results indicate that none of the confidence intervals of the ϕ values (\pm two standard errors) include the value of one thereby providing the evidence of discriminant validity (Bagozzi & Yi, 1988). Further evidence of convergent validity were the average variance extracted (AVE) values which were all above the threshold of .50 indicating that the constructs contained less than 50% error variance (Fornell & Larcker, 1981). Discriminant validity was further established after knowing that the square root of each construct's AVE was found to be larger than its correlations with other constructs as shown in Table 3 (Fornell & Larcker, 1981; Hair et al., 2006).

[Insert Table 3. Descriptive Statistics and Correlations here]

The overall goodness of fit indices indicated that the measurement model fit the data well as evidenced by the goodness of fit measures. The results of the ROBUST Method offered by EQS to examine the model in case of slight departures from the normality assumption of data distribution, confirmed the results generated by the maximum likelihood technique.

Overall, the results of the test of the measurement model-data fit suggested that the constructs used in this study possessed satisfactory level of construct validity, internal consistency (i.e. reliability), convergent as well as discriminant validity. Table 3 shows the means, standard deviation and correlations of the six constructs used in the succeeding analysis of the structural model-data fit.

Hypothesis Testing

Results from fitting the structural model to the data using maximum likelihood technique showed satisfactory results as shown by the goodness-of-fit measures shown in Figure 2. Because Mardia's coefficient of 30.51 was far above the maximum threshold of 5.00 (Byrne, 2006) indicative of non-normal distributions, the ROBUST technique was also applied using EQS and the output confirmed the maximum likelihood technique results.

[Insert Figure 2. The Structural Model here]

The results showed that all the variables had variances that were statistically different from zero which indicated that each variable was highly distinguishable (i.e. distinctive) from one another (Bentler, 1995). All the institutions explained 65% of the variations in the firm's strategic posture whilst strategic posture explained 29% of the variations in the firm's organisational performance. Rule of law has the largest impact on entrepreneurial strategic posture, followed by government policies and regulatory quality. The empirical evidence indicates that all the formal institutions are positively associated with an entrepreneurial strategic posture, supporting H_1 , H_3 , H_4 , and H_5 . H_2 was not tested due to the psychometric issues associated with the construct protection of property rights (the variable which was subsequently subsumed under rule of law). Strategic posture on the other hand showed a positive significant relationship with organisational performance – a result that was consistent with H_6 .

The r^2 values (being the derivatives of the Pearson r), suggested that the *effect sizes* for the institutions → strategic posture paths and strategic posture → organisational performance path were considered medium and large effects, respectively (Field, 2005). These indicators of effect size suggested that despite having relatively small yet significant path coefficients, the results could be considered practically significant and meaningful from which inferences could be drawn (Cohen, 1992; Field, 2005; Pedhazur, 1982).

Mediation Analysis

Mediation analysis is the process of establishing that strategic posture intervenes or mediates the relationships between the informal institutions and organisational performance. The process follows the standard approach proposed by Baron and Kenny (1986) such that: (a) the independent variables (IV) must be correlated with the dependent variable (DV) to gauge the *total effect*; (b) the IV must be correlated with the mediating variable (MV); and (c) the MV must be correlated with the DV with the IV controlled for in the model to gauge the *direct effect*. In the last step, partial mediation is indicated by beta weights of the IV remaining significant. If these turn out to be not significant, complete mediation is detected. The *indirect effect* may be determined by getting the difference between the *total effect* minus the *direct effect*. Table 4 shows the results of the mediation analysis.

[Insert Table 4. Mediation Analysis here]

The four formal institutions which had significant relationships with strategic posture were also shown to have direct effects on organisational performance as shown in Table 4. Subsequently mediation analysis was performed with respect to these relationships (Baron & Kenny, 1986). The partial mediation suggested that strategic posture only partially explained the relationships between the four formal and organisational performance. In other words, factors other than the firms' strategic posture may also explain how these selected formal institutions impact the firms' performance. In effect, H_7 was partly supported by the data.

Discussion

The study's novel attempt at operationalising North's (1990) formal institutions and empirically relating them to firm-level phenomena is a contribution to understanding the nature and magnitude of impact on institutions at the city-level in an emerging economy context. This attempt manifests the originality of the study relative to previous studies focusing on either relationships between country-wide formal institutions and macro-economic variables or theoretical/conceptual discussions of informal institutions.

The study's theoretical contribution is the generation of empirical evidence supporting the view that city-level formal institutions matter too in explaining firm-level phenomena such as the firm's strategic posture (North, 2005). That formal institutions are the invisible factors acting as constraints and incentives is an inference that can be derived from the results. The

empirical evidence shows that an entrepreneurial strategic posture is likely to thrive in an environment characterised by the presence of rule of law, government policies perceived as supportive of SMEs, regulatory quality that does not impose unreasonable burden on SMEs, and government assistance available to SMEs.

As expected, an entrepreneurial strategic posture shows positive relationship with organisational performance consistent with previous studies (Avlonitis & Salavou, 2007; Barret, Balloun & Weinsten, 2000). When SMEs report that they engage more on proactive activities, take more risks in their business operation, and take very opportunity to be proactive by leading the industry vis-à-vis other players or competitors, they also report better organisational performance outcomes. This result lends further support to the sustainability of the strategic posture-firm performance relationship (Wiklund, 1999).

The mediation analysis provides a different perspective in interpreting the overall results of the study such that the all of the formal institutions have been shown to be associated with strategic posture, which in turn, has been shown to be associated with organisational performance. In effect, the mediation analysis made clear that the institutional environment has the greatest impact on SMEs, through the former's influence with the latter's exercise of strategic posture.

There are important lessons that can be derived from the results of this study. One lesson is that SMEs operating in an emerging economy have to deal with the pressures of the institutional environment in addition to market- and industry-related forces. In effect, SMEs have to face a set of formidable and complex environmental hurdles as they strive for greater performance. These external pressures have significant impact on the ultimate growth and survival of SMEs doing business in these institutionally- diverse economies.

Likewise, foreign firms that are planning for international business activity in emerging economies like the Philippines should take into account the institutional landscape not only of the country as a whole but of the specific localities as well. Doing so allows a foreign firm to equip itself with the capability to respond well to these institutional variations which will have significant bearing on the firm's strategic directions in the domestic market. Being mindful of the institutional environmental factors such as rule of law, for instance, can spell a difference in terms of marketing products or services and at the same time, minimising, if not avoiding, the negative impact of counterfeiting or piracy. Familiarisation of these institutional variations forewarns a foreign firm with respect to the requirements for doing business or judicial resolution of commercial disputes. In effect, foreign firms may slightly increase their chance of success in entering the local markets within an emerging economy if they give careful consideration to the sub-national institutional elements that are associated with strategic business behaviour.

Conclusion and Implications for Further Research

The attempt to enrich understanding of the fundamental tenets of institutional theory in an emerging economy context could be considered as the major theoretical contribution of the study. The original theory explains why and how institutions matter in the environment – strategy – firm performance nexus. The current study explains how they matter in a specific context – that is, on SMEs in a sub-national, emerging economy setting. The current study yielded empirical evidence supportive of the study's overarching thesis that formal institutions have strong influence on the strategic posture of small firms.

These institutions are a source of constraints and benefits that substantively influence a SMEs' strategic posture and ultimately, organisational performance. The extent to which these institutions are perceived to be supportive of risk-taking initiatives, proactiveness, and innovativeness has been shown to be related to the entrepreneurial nature of the firm's overall strategic posture. Consequently, when firms take on a more entrepreneurial strategic posture, they are likely to generate favourable gains in overall organisational performance.

Future research directions include a longitudinal studies being a potential area for future research action as it may uncover variations in formal and informal institutions, strategic posture and firm performance over time. It may be able to find out if there will be shifts (i.e. non-entrepreneurial to entrepreneurial) in strategic posture given a set of institutions that are consistently perceived negatively (or positively) by SMEs over time. Markets are also shaped by institutions (Herrschel & Newman, 2000) Examining how these institutions affect SME's markets and industries may be worth pursuing in the future.

Future studies may be undertaken using triangulated data gathering methodology to supplement and enrich the results of current research. Studies may be designed using objective representations or proxy for informal institutions, strategic posture and performance. Studies exploring those much more firm-specific formal institutions in the context of North's view on institutions (1990) are interesting research worth the effort. An investigation of firm- or industry-specific formal institutions may shed more light on the role of institutions in entrepreneurial development in particular, and economic performance in general.

Institutions matter to SMEs because they provide the structure, set constraints and offer incentives that could support or inhibit the proactive, risk-taking and innovative activities of these small firms. The environmental incentives/constraints emanating from formal and informal institutions define the institutional landscape through which (un)productive entrepreneurial activities could take place. The structural model tested in this study offers a new way of looking at the relationships between the institutional environment and the strategic choices SMEs make in pursuit of sustainable returns on performance.

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Figure 1. The Conceptual Framework

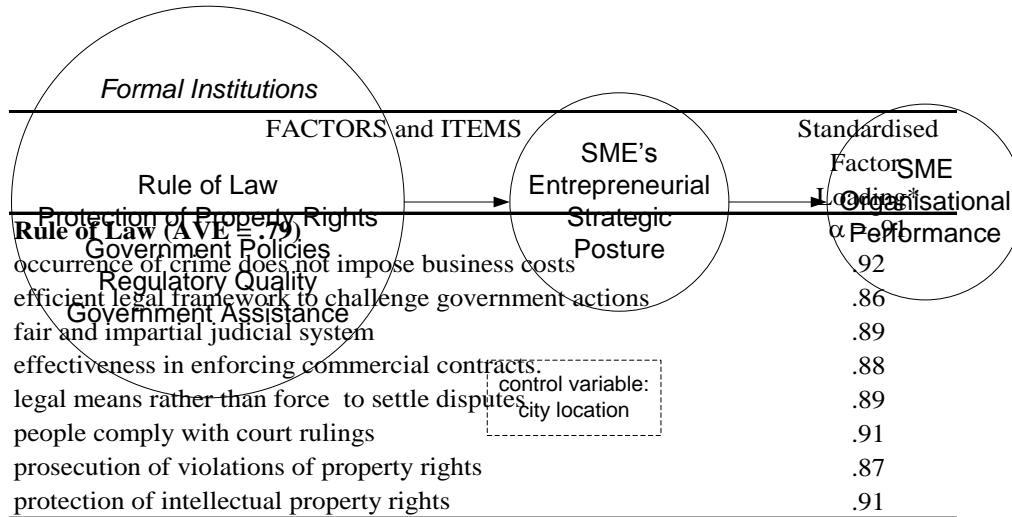


Table 1.

The

*all significant at .05 (i.e. test statistic > ± 1.96)

AVE = average variance extracted based on standardised solution

α = Cronbach alpha

Measurement Model

Table 2. Goodness-of-Fit Measures

Constructs	χ^2	NFI	CFI	RMSEA
Formal Institutions - <i>Model A</i>	10,350.49, 350 <i>df</i> , <i>p</i> = .00	.68	.69	.18
Formal Institutions - <i>Model B</i>	8,574.95, 299 <i>df</i> , <i>p</i> = .00	.92	.91	.06
Entrepreneurial Strategic Posture	612.93, 27 <i>df</i> , <i>p</i> = .00	.93	.93	.14
Organisational Performance	4.37, 2 <i>df</i> , <i>p</i> = .11	.99	.99	.03

Model A - retained all factors and items

Model B - retained all factors/items but combined all items for rule of law and protection of property rights and dropped two items under protection of property rights

NFI - Bentler-Bonnett's Normed Fit Index

CFI - Comparative Fit Index

RMSEA - Root Mean-Square Error of Approximation

Table 3. Descriptive Statistics and Correlations

Variables	Mean	SD	RL	GP	RQ	GA	SP	OP
Rule of Law (RL)	4.62	1.30	.89					
Government Policies (GP)	4.30	1.77	.88*	.92				
Regulatory Quality (RQ)	4.30	1.53	.87*	.80*	.90			
Government Assistance (GA)	2.28	.88	.25*	.24*	.21*	.77		
Entrepreneurial Strategic Posture (SP)	3.62	1.38	.86*	.81*	.79*	.35*	.87	
Organisational Performance (OP)	14.88	3.75	.47*	.45*	.42*	.13*	.49**	.78

*significant at the .01 level (2-tailed)

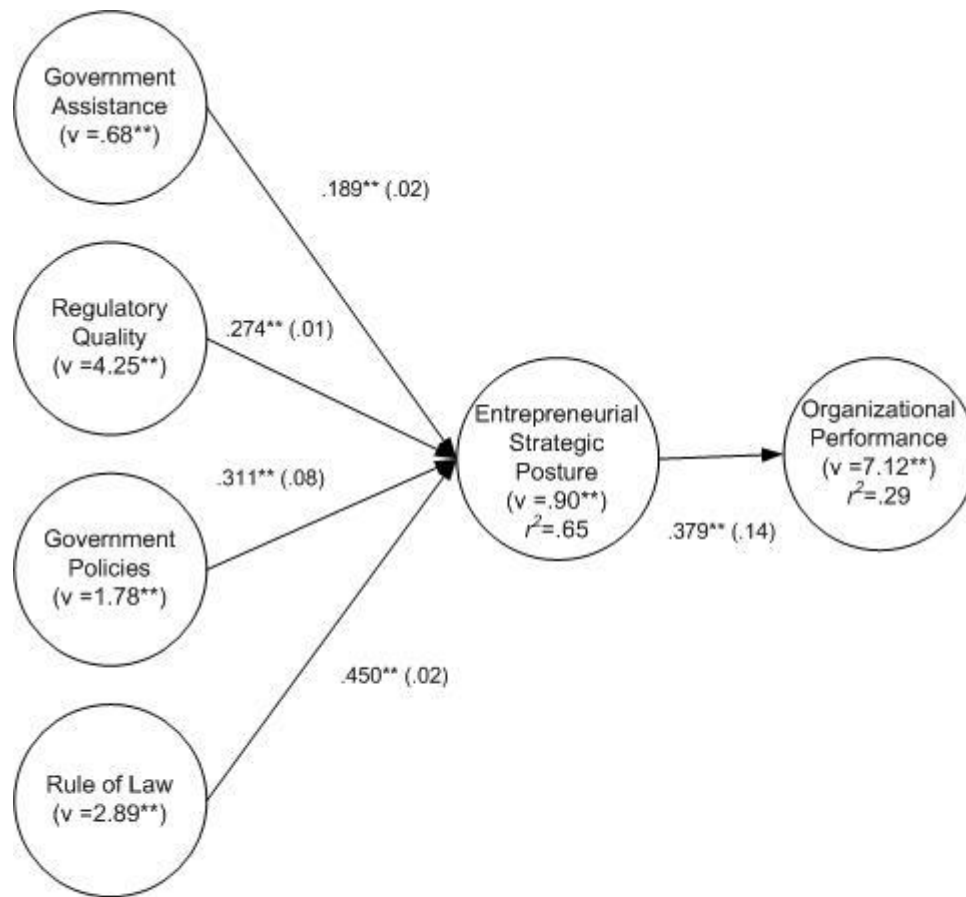
**significant at the .05 level (2-tailed)

square root of average variance extracted (*ave*) values in diagonal and bold figures

Table 4. Mediation Analysis

Constructs	A ^a	B ^b	C (A-B)	Extent of Mediation
	Total Effects	Direct Effects	Indirect Effects	
Rule of Law → Org. Performance	.248** (.06)	.145** (.06)	.103	<i>partial</i>
Government Policies → Org. Performance	.737** (.09)	.624** (.08)	.113	<i>partial</i>
Regulatory Quality → Org. Performance	.230** (.05)	.105** (.05)	.125	<i>partial</i>
Government Assistance → Org. Performance	.133** (.13)	.101** (.14)	.032	<i>partial</i>
Goodness of Fit Measures:				
χ^2	13,465.87	13,454.96		
<i>df</i>	1,701	1,700		
<i>p</i> value	.00	.00		
NFI	.93	.94		
CFI	.92	.95		
GFI	.90	.92		
RMSEA	.07	.06		
^a controlling for city location				
^b controlling for city location and mediating variable (i.e. Strategic Posture)				
**significant at <i>p</i> > .05, (standard errors)				
<i>n/a</i> - not applicable				

Figure 2. The Structural Model



Goodness of Fit Measures:
 $\chi^2 = 12,092.81$, 1700 df ($p > .000$), NFI = .92, CFI = .94, RMSEA = .06
 v = variance, ** significant at $p < .05$, (standard errors)
 control: city location