



INTER-FIRM LINKAGES, BUSINESS STRATEGIES,
AND PERFORMANCE OF MICRO AND SMALL
ENTERPRISES: A CASE STUDY OF MICRO AND
SMALL INDUSTRIAL CLUSTERS IN THE
PROVINCE OF CENTRAL JAVA, INDONESIA

BY

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ABSTRACT

This study investigates the interplay of inter-firm linkages and business strategies and their impacts on performance of micro and small enterprises (MSEs) that operate in small industrial clusters in the Province of Central Java, Indonesia. Many studies in this field were commonly conducted in partial works whilst a substantial work that discussed a more comprehensive picture on their development by means of focusing on *causal nexus* of inter-firm linkages, business strategies and performances of MSEs which were constructed in an integrated model has not been explored in detail. As an attempt to fill the gap, this study intends to examine twofold namely (1) the relational dimensions of inter-firm linkage mechanism and business strategies on performance of MSEs and (2) the pathways in which MSEs have benefited the linkages and business strategies to attain their goals. To do so, this study carries out an empirical assessment of the *causal nexus* connecting inter-firm linkages and business strategies to performances of 310 MSEs that operate in 14 small industrial clusters in Central Java. Given such triangular relationships, this study found that inter-firm linkages seem to be less effective in affecting MSEs' performances rather than business strategies. Based on qualitative data collected from the field survey, it is found that the lack of trust among the clustered entrepreneurs and the existence of institutional problems caused the ineffectiveness of inter-firm linkages to positively contribute to MSEs' performances. As a result, while MSEs in the clusters cooperate with each other as a consequence of proximity advantage of clusters, they also hinge on their own business strategies in order to attain better performance of the firms.

خلاصة البحث

تتناول هذه الدراسة بعمق التفاعل بين الروابط فيما بين الشركات و استراتيجيات الأعمال وتأثيراتها على أداء المؤسسات مايكر والصغيرة (ESMs) micro and small s enterprise) التي تعمل في التجمعات الصناعية الصغيرة في مقاطعة جاوة الوسطى، اندونيسيا. ومع ذلك، أجريت الدراسات الموجودة عموما في أعمال جزئية في حين عمل كبير أن مناقشة شاملة صورة أكثر على تنميتها من خلال التركيز على العلاقة السببية بين الشركات من الروابط المشتركة واستراتيجيات الأعمال وأداء المؤسسات مايكر والصغيرة والتي شيدت في نموذج متكامل لم يتم استكشافها في التفاصيل. انها محاولة لملء الفراغ، فإن هذه الدراسة تعتمز دراسة ذات شقين هما (1) أبعاد علائقية من شركة الربط الآلية المشتركة بين استراتيجيات الأعمال التجارية على أداء المؤسسات مايكر والصغيرة و (2) في المسارات التي استفادت المؤسسات مايكر والصغيرة الروابط واستراتيجيات الأعمال التجارية لتحقيق أهدافهم . للقيام بذلك ، فإن هذه الدراسة تقوم على تقييم العملية على علاقة سببية تربط بين الروابط فيما بين الشركات والاستراتيجيات التجارية لاداء 310 المؤسسات مايكر والصغيرة التي تعمل في 14 التجمعات الصناعية الصغيرة في جاوة الوسطى. نظرا هذه العلاقات الثلاثية، وجدت الدراسة أن هذه الروابط فيما بين الشركات يبدو أن أقل فعالية في التأثير 'الأداء المؤسسات مايكروالصغيرة بدلا من الاستراتيجيات التجارية. وبناء على البيانات النوعية التي جمعت من المسح الميداني، وجدت فهي أن انعدام الثقة بين رجال الأعمال عنقودية ووجود المشاكل المؤسسية سبب عدم فعالية الروابط فيما بين الشركات للمساهمة بشكل إيجابي في 'الأداء المؤسسات مايكروالصغيرة. والنتائج، في حين المؤسسات مايكر والصغيرة التي تعمل في التجمعات الصناعية الصغيرة تتعاون مع بعضها البعض نتيجة لميزة القرب من التجمعات، فإنها تتوقف أيضا على استراتيجيات أعمالهم الخاصة من أجل تحقيق أفضل العروض من الشركات.

APPROVAL PAGE

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DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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Signature:

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THE PROVINCE OF CENTRAL JAVA,
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Affirmed by Arif Hoetoro

.....

Signature

.....

Date

This dissertation is dedicated to

*My father: Bapak Haji Moestadjab
My mother: Ibu Hajjah Moektachiroh
My mother in law: Ibu Hajjah Siti Chotidjah*

This dissertation is especially devoted to

*My beloved wife:
Naili Mukhsinah, B.Ed*

*My beloved son and daughter:
Dzulfikar Ontoseno & Nayra Ilmayni Hutari*

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CHAPTER ONE

INTRODUCTION

1.1 OVERVIEW

It has been generally recognized that micro and small enterprises (MSEs) play vital roles in economic development. MSEs contribute immensely towards employment creation, broader investment allocation, and income distribution (Amini, 2004; Hasan and Khor, 2009) as well as often acting as incubators for large enterprises (Weber and Žnidaršič, 2010). The recognition of such important contributions is not prejudicial to MSEs' indispensability for national economic growth and development. Ayyagari (2006) highlighted three points in this regard. *First*, MSEs, especially young enterprises, contribute much to innovation and entrepreneurship in the economy. *Second*, MSEs generate dynamism and flexibility to the economy by way of creating new firms, adding to the competitive forces and less expensive adjustments to economic shocks. *Third*, MSEs play a strategic role in the national economic and social transformation by means of their linkages with other firms (Ayyagari, 2006).

Besides many advantages that MSEs contribute to the economic development process, their relatively small size often acts as a significant disadvantage across key operational and strategic dimension. In financial matters, for instance, MSEs undergo great difficulty in acquiring external capital necessary for rapid growth (Keskin and Şentürk, 2010). Moreover, in their bid to enhance economies of scale, MSEs often face numerous entry barriers when they intend to integrate their product lines into a broader system (Rothwell and Beesley, 1989). As such, difficulties faced by MSEs are

not always purely in terms of size and lack of resources but also in terms of their isolation of operation and interaction with other enterprises (Harvie, 2007).

Given their foregoing peculiarities, MSEs often operate in limited space to achieve their goals. They practically require supports and resources from external agents such as from relatives and friends, supporting institutions (banks and other financial institutions, agents for incubating small business, and government regulations), or other firms (Urban et al., 2000; Wattanapruttipaisan, 2002; Beaver, 2002; Roxas et al., 2007). In this regard, quite archetypal of MSEs, their operational efficiency is hinged on, among other things, the so-called inter-firm cooperation (Felzensztein et al., 2010), inter-firm relationships (Phele et al, 2004; Saito et al., 2007) or inter-firm linkages (Sato, 2000b).

In today's global economy, the role and significance of inter-firm linkages are becoming increasingly common around the world (Urban et al., 2000). The linkages provide MSEs with a vast opportunity to overcome their development constraints (Barber et al., 1989; Jalal, 1997). Firms having varieties of linkages also stimulate product, process, procurement, and market creating innovation (Machikita and Ueki, 2010). For example, business linkages formed in small industrial clusters facilitate MSEs in obtaining location and proximity advantages by providing them with channels to resources fulfillment and value-added services close to the end users (Nadvi, 1999a; Kuah, 2002; Kuncoro and Supomo, 2003). Felzensztein (2003) pointed out that business linkages found in clusters benefit MSEs in many ways. For instance, the linkages offer MSEs with more flexible and specialized production since the cooperation among the firms raises the efficiency in production. The linkages also facilitate MSEs with better information flow and vast space to increase innovation.

Another example of inter-firm linkage benefits is reflected in the subcontracting linkage the MSEs engage in. A notable example in this regard may be rural metal-casting enterprises in Ceper, Central Java in which case Sato (2000b) showed that the linkage has succeeded in promoting MSEs development. When MSEs in such rural industry developed subcontracting with assemblers in the urban modern sector, the linkage provides benefits beyond product sales. Rather, numerous firms are stimulated to improve innovation and technological capabilities through the linkage system. Accordingly, such a subcontracting linkage is very significant for further development of MSEs located in that rural area.

However, a successful inter-firm linkage is not merely determined by the linkage mechanism itself. Viewed from contingency approach that attempts to establish functional relationships between environmental variables and organizational variables (Boyoung, 2010), it is arguable that applying inter-firm linkages effectively is dependent upon such factors as strategy and managerial preferences. It is also worth mentioning that as business relationships are often based on both cooperation and competition (Solitander and Tidström, 2010); a firm must manage a delicate balance between inter-firm linkages and strategic plans that need to be withheld from partners. Therefore, a successful inter-firm linkage should possess an ability to have equally adaptable business strategies along with firm development (Harvie, 2007) which in turn the both can increase firm performance.

In light of the foregoing notions, this study investigates inter-firm linkages, business strategies and their impacts on MSEs' performance in the Province of Central Java, Indonesia. Differed from the existing researches, this study primarily focuses on *causal relationships* of inter-firm linkages, business strategies and performances of MSEs; constructed in an integrated model. The model is then expected to provide a

comprehensive picture of how MSEs establish inter-firm linkages and apply their business strategies to achieving their advanced development simultaneously.

1.1.1 Inter-firm Linkages, Business Strategies and Performances of MSEs

Inter-firm linkages among MSEs commonly emerge when MSEs create forward, backward, and horizontal linkages (Stanton and Polatajko, 2001; Ayyagari, 2006). Besides, inter-firm linkages also evolve in many types of the linkages such as subcontracting, franchising, input and output linkage, and clustering. All these forms and types of inter-firm linkages provide MSEs with potentials to overcome their growth constraints. This is usually by promoting collective efficiency, facilitating the firm growth in small steps, and making it easier to respond to business opportunities (Clark, 1995; Ingley, 1999; Nakizito and Darkoh, 2002). These linkages, especially the financial linkages, provide more benefits particularly to MSEs in the start-up stage. This is more so since accessibility to adequate start-up capital has been identified as an important deterrent to MSEs' growth (Trillo et al., 2003).

For such reasons, an increasing attention to inter-firm linkages practiced by MSEs is understandable and may likely to continue. This assertion is arguably hinged on the fact that the linkages provide economic benefits to MSEs. Such benefits are usually derived either from economies of scale (in purchases, sales, dealing with the public sector, etc.); from dissemination of information (on technology, on market, etc.); or from division of labor (Berry, 1997). Particularly, these economic effects are obtained in many forms such as increase in demand, technological know-how improvement, and amplification of bulk of buyers (Cooke and Wills, 1999; Grierson et al., 1999; Knopp, 2002; Mullei, 2003; Dornberger and Utama, 2006). Besides, the formation of inter-firm linkages also becomes a strategic instrument for managing the

value chain and competitive success. This is by channeling MSEs towards seeking the most economical and efficient way of sourcing the skills, materials, and services needed to produce commercial goods (Stanton and Polatajko, 2001; Kuah, 2002).

However, whether or not those benefits are achieved depends on how MSEs respond to the inter-firm linkage mechanism. In line with the views of Janczak and Bares (2010), it related to a capability of a firm in connecting its internal strength and external needs. Therefore, the condition of internal capacity and business strategies applied by an enterprise will influence the effectiveness of the linkage formation (Todeva, 2006). The relationships between the both reflect an innovative way of MSEs to boost their acquisitional capability which, in turn, affects their performance. McGovern (2005) pointed out that by developing inter-firm linkages MSEs have a vast space to renew their strategies when they intend to augment their existing capabilities. The linkages provide MSEs with a condition; while they still compete in a sector, they also create a context within which they can co-evolve, especially in areas of acquisitional capability (McGovern, 2005).

Viewed from the perspective of resource acquisition to augment internal capacity, inter-firm linkages formed among MSEs are potential to provide operational performance benefits to the firms. This offers a capability to acquire the resources that, in turn, yield benefits to the firm's internal operations (Todeva, 2006). Similarly, Rungtusanatham et al. (2003) stated that when a firm creates linkages with other firms, the resulting connections provide competitive benefits to the firm by facilitating the management of material flow (i.e. raw materials) into and out of (i.e. finished goods) the firm. These benefits, in turn, accrue directly to operational performance of the firm.