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**Strategic Issues in SME's**

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## **Abstract**

*Although, Small and Medium Enterprises (SMEs) are a major employment provider and contributor to GDP, they are burdened with the responsibility of providing employment while at the same time experiencing sluggish growth because of dwindling agricultural sector and globalization. SMEs are characterized by flexibility, small scale, traditional technology, etc. The SME sector targets both domestic as well global markets. Globalization opens a window of opportunities and threats for SMEs. Government's programmes are unstructured and vague, and fall short of delivering the intended outputs. This necessitates the enterprise to think strategically by focusing on major issues. The success of an enterprise is embedded in gaining competitive advantage. This paper focuses on such strategic issues which drive SMEs towards comparative advantage. Some major strategic issues identified are institutional issues, strategic entrepreneurship development, social capital, cluster development, innovation, and e-commerce.*

**Key words: Competitive advantage, cluster, e-commerce, globalization, innovation, social capital.**

## **Introduction**

Although, Indian Small and Medium Enterprises (SMEs) account for 40% of the industrial production, 35% of the total manufactured exports of the country, 95% of all industrial units and about 70% of employment<sup>1</sup>, they are under tremendous pressure of providing employment and experiencing sluggish growth because of dwindling agriculture sector and globalization. The Government of India (GoI) has recognized the potential of SMEs as significant contributors to economic growth and GDP, and supports SMEs in terms of providing entrepreneurial training, technological up-gradation, financial assistance, market provision, raw material supply, etc. Despite these supportive measures, the small scale industry is unable to come out of its moribund situation. There are two reasons, the first is the high administrative cost and lack of managerial and executive capacity and the second is that policies mostly favour large firms (Schmitz and Musyck, 1994). Besides, other possible reasons could be that the present government policies are unable to target strategic issues of industries which lead SMEs towards competitive advantage.

The Reserve Bank of India (RBI) defines SMEs as small scale industrial unit, an undertaking in which investment in plant and machinery does not exceed Rs.1 crore, except in respect of certain specified items under hosiery, hand tools, drugs and pharmaceuticals, stationery items and sports goods, where this investment limit has been enhanced to Rs. 5 crore. SMEs are established in almost all major sectors such as agriculture, food processing, chemical and pharmaceutical, sports goods, leather and leather goods, plastic products, computer software, and engineering, electronic and electronics, etc. (Sampath, 2006). The Indian SME segment's current production value is almost Rs 816,000 crores, manufacturing more than 8,000 diverse products, ranging from low-technology items to technologically advanced products. The SME sector targets both domestic as well global markets. The industry groups with a large share in exports are hosiery and garments (29.0%), food products (21.4%) and leather products (18%) (OECD Economic Surveys: India, 2007).

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<sup>1</sup> Source: Office of Development Commissioner, Ministry of Micro, Small and Medium Enterprises, Government of India, available at: [www.laghu-udhog.com](http://www.laghu-udhog.com)

The industry sector, especially SMEs, plays a significant role in a developing country economy such as India. SMEs possess certain characteristics that make them vital for the Indian economy. These include greater operational flexibility, high propensity to adopt technology, high capacity to innovate export, high employment orientation, utilization of locally available human and material resources, reduction of regional imbalances<sup>2</sup>, rapid and effective internal communication, shorter decision chains, capable of fast learning and adapting routine and strategy (Das, 1996). Despite these benefits, SME's own inherent characteristics trap them into lethargic growth. These include small size, traditional technologies, low capital investment mostly because of financial problems, low scale of economies, mostly family-owned enterprises (Varma, 2002), and insufficient division of labour (Saith, 2001). This paper focuses on some strategic issues pertaining to SMEs, such as institutional issues, strategic entrepreneurship development, social capital, cluster development, e-commerce, and innovation. Each of these strategic issues is centered towards competitive advantage, which implies that these issues help the firm acquire a position that cannot be duplicated or imitated by other firms or in other words one firm has relative advantage over its competitors in which its earnings exceed cost (Porter, 1980).

### **Strategic Issues in SMEs**

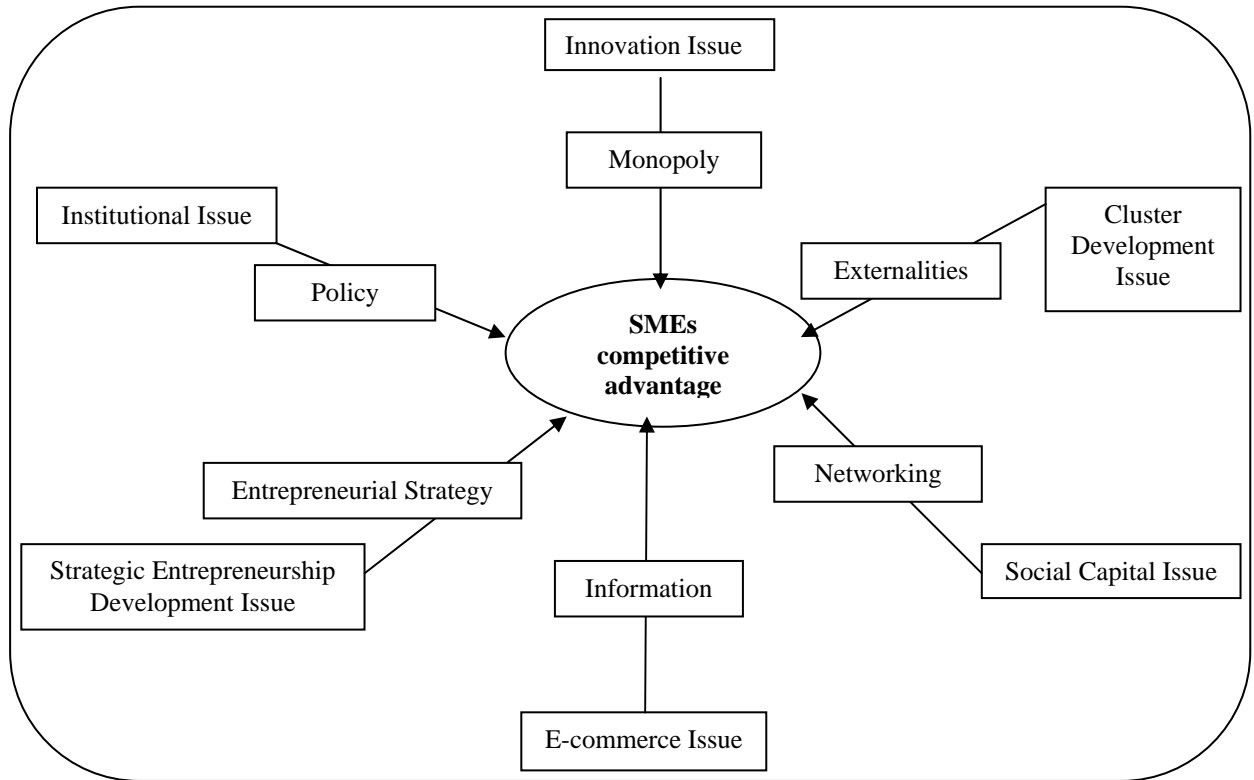
A strategic issue is define as external (King, 1981) or external and internal (Dutton and Ottensmeyer, 1987) event or condition or trend of an organization which affects firm performance (Schneider and Arnoud, 1991). Strategic issues focus towards competitive advantage and emphasize major comparative strategies identified by Porter as cost reduction and differentiation. These strategies are tied to focusing on improving product quality by differentiation at minimum cost.

This paper spotlights such strategic issues as presented in Figure 1. SME's flexibility proves to be the greatest advantage which makes the firm flexible enough to adopt different strategies. Each strategic issue affects SMEs by targeting a specific approach. Institutional issues affect SMEs through the by formulation and implementation of policies. Cluster creates externalities in the form of collective efficiency and

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<sup>2</sup> Source: Data and definition of SME are taken from official site of [www.smeindia.com](http://www.smeindia.com)

commonalities, simultaneously promoting social capital and innovation. Social capital provides competitive advantage by generating networks among firms.



**Figure: 1 Strategic Issues Framework of SMEs**

Strategic entrepreneurship develops potential in SMEs so that they are able to identify opportunities and act strategically on them. Emerging e-business technologies endow SMEs with latest information in a short period of time. And finally innovation strides SMEs towards monopoly which in turn increases entrepreneurial profit.

### **3.1. Institutional Issues**

Government strategies for SMEs include reservation of certain products specific to SMEs, financing, subcontracting, ancillarisation, technology support centers or research and development centers, and entrepreneurship development institutes, etc. Generally, these strategies favour large firms and fail to boost up the growth of SMEs. This clearly reflects lack of strategic approach. It has been arguing that just providing an entrepreneurial training, financing, and providing technology which most of the time is

not concerned with small firms, is not going to solve the problems of SMEs. The need of the hour is commercialization of technologies with minimum cost and lower risk involvement so that SMEs can achieve competitive advantage. Keeping this in view, government is now focusing on cluster development, and for the first time has formulated a cluster development policy in the Tenth Five Year Plan. United Nations Industrial Development Organization (UNIDO)<sup>3</sup> is playing a leading role in development of clusters in India. UNIDO works on the basis of collective beliefs, it creates and provides specialized techniques and promotes inter-firm co-operation through networking with other SMEs, larger enterprises, support institutions local government, banks, business schools, etc. Government has included innovation in its policy for technology transfer for better utilization of local resources and for achievement of local self-sufficiency rather than research and development and innovation assistance (Khan and Ghani, 2004).

### **3.2 Strategic Entrepreneurship Development**

Entrepreneurship entails identification and exploitation of opportunities in the business environment, and strategic entrepreneurship refers to entrepreneurial action with a strategic perspective. In other words, strategic entrepreneurship is the integration of entrepreneurial (opportunity-seeking behaviour) and strategic (advantage seeking) perspectives in developing and taking action designed to establish competitive advantage (Hitt, Ireland, Camp, and Sexton, 2001).

Strategic entrepreneurship development trains an entrepreneur to focus on niche markets untapped by large firms because of their cost structure, and which can be easily targeted by SMEs. Strategic actions include external networks, resource and organizational learning, innovation and internationalization. External networks include relationships with customers, suppliers, and competitors among others and extend across industry, geographic, political, and cultural boundaries. They provide information, market, resources, legitimacy, and technology. Resources basically focus on intangible resources such as reputation and knowledge. Learning new capabilities helps firms compete effectively, survive, and grow in the changing business environment. Innovation is described as a separate strategic issue in this paper. Globalization increases opportunities

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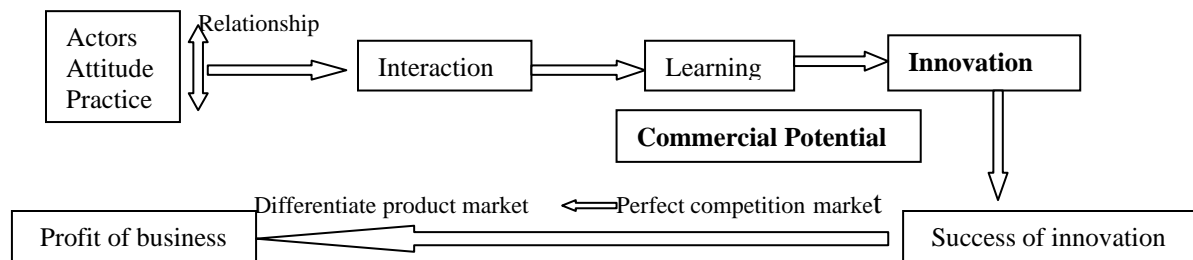
<sup>3</sup> Source: Official site of United Nations Industrial Development Organization (UNIDO)

for export for the firm, thereby leading to internationalization (Hitt, Ireland, Camp, and Sexton, 2001). Borch (2004) emphasizes dynamic capability as a strategic move by small firms concerned with reducing the path dependency of earlier strategic adaptations and resource bundling, capabilities that add new valuable resources both through internal learning processes and external acquisition, and finally, capabilities that balance the present and the future paths of the firm making it possible to exploit successful strategies of the present and at the same time prepare for the future.

### 3.3 Innovation

Innovation refers to creating new resources or combining existing resources in new ways to develop and commercialize new products, move into the new markets, and/or services, and acquire new customers (Swedberg, 2000). Innovation provides the entrepreneur a chance to become a first mover, by which he/she can gain profit because of monopoly until a competitor imitates its new product or finds a substitute.

Small firms will become superior if the optimal development costs are low. Small firms will tend to specialize more in the research phase and in smaller development processes (Swedberg, 2000). Their comparative advantages over large firms in innovation come from their flexibility and speed of response. Some factors that have been found to be influential for innovation in SMEs are classified into two categories, namely, internal and external. Internal factors are self-motivation, technical education, and work experience.



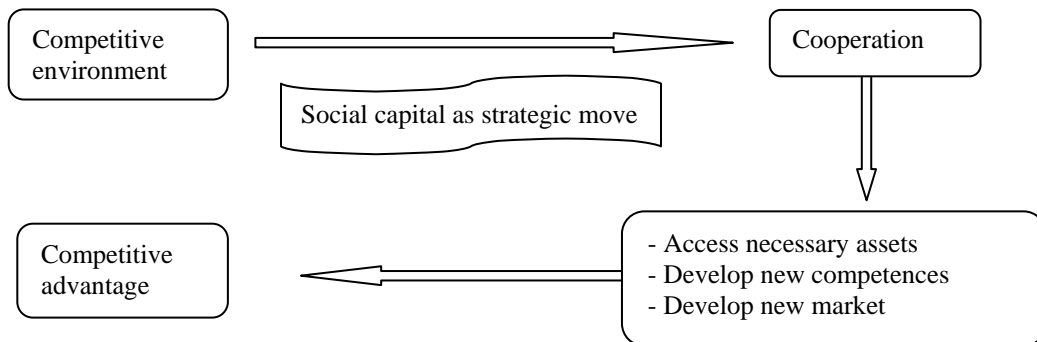
**Figure 2: Actors, Institutions and Their Interactions as Drivers of Innovation**

External factors include customer touch, subcontracting relationship with a large firm, research institute interaction, and government and non-government promoted SME support organization, financial organization and competition and technology change

(Subrahmanya, 2006). Innovation cannot be studied in isolation because it is a process which comprises of actors, institutions and their interactions as depicted in figure 2.

### 3.4 Social Capital

Putnam defines social capital as the “features of social organization, such as trust, norms, and networks that can improve the efficiency of society by facilitating co-ordinate actions” (Wallis, Killerby and Dollery, 2004). Network is defined as the complex web of linkages of a specific individual or firm with other individuals and/or firms. It can also be referred to as the entire set of linkages among a finite collection of agents (Durlauf, Fafchamps, 2004). Small firms lack resources, due to which they need to depend on large firms, thus building relationships not only with large firms but also with NGOs, government and other development institutions, research institutions, non-profit and for-profit organizations. These linkages help resolve conflict, build trust, and speed possibilities for partnership. Figure 3 depicts how competitive environment impinges upon a firm, and leads it to develop cooperation with other firms, which enables it to gain competitive advantage.



**Figure 3: Cooperation as a Source of Competitive Advantage**

(Source: Laerve and Heene, 2003)

Cooperation through network linkages is the major source of access to information, resources, and markets and even, at times, technologies for the firm. Networks provide credit, access to distant markets, lower the risk involved in business by avoiding opportunistic behavior and lower down the transaction cost thereby enabling the firm to acquire competitive advantage (Iyer and Toh, 2005).

### **3.5 Cluster Development**

A cluster consist of groups of associated and interconnected firms that are linked vertically and/or horizontally through their commonalities and complementariness in products, services, inputs, technologies or outputs activities, transportation, warehouse, and communication (Porter, 1998). These commonalities lead towards interrelationships and trust, thus building collective efficiency. These commonalities may be source of information about competitor behavior, new technology developments, and other industry trends. This information is critical for future decisions regarding cooperation for product development and commercialization (Walker, Kogut, and Shan, 2001). India presently has more than 400 modern and around 2000 old clusters (Das, 2005). Some of the popular clusters are the knitwear cluster in Ludhiana, gems and jewelry cluster in Surat and the leather products cluster in Agra, etc.

Clusters can provide competitive advantage to the firms by affecting competition in three ways, namely, productivity (better access to employees and supplier, access to specialized information, complementarities, access to institutions and public goods, better motivation and measurement), innovation (provide window for customer, make companies learn about technology component, machinery availability, service and marketing concepts, provide capacity and flexibility), and finally formation of new business firms (concentrated customer based, individuals working within a cluster can more easily perceive gaps in products or service around which they can build business, resource availability and stimulate networking among firms) (Porter, 2000).

In a cluster, small firms have some advantages such as access to markets, both domestic and international, credit, and raw material (Smyth, 1992). Cawthorne (1995) has defined vertical and horizontal relations in terms of outcontracting which take place between firms specializing in different processes and enable firms to make choices about the extent to which they vertically integrate parts of the production process, and incontracting, which develops within some of the larger firms where job-work contractors are employed for each unit.

### **3.6 E-Commerce Issues**

Terms such as e-business, e-commerce, net shopping, online retailing, e-culture, e-age, the virtual world and portals are now becoming part of the new business language (RIGA, 1998). E-commerce is defined as sale or purchase of goods or services through the application of information and communication technology from its point of origin to its endpoint along the entire value chain of business processes conducted electronically and designed to enable the accomplishment of a business goal (Wigand, 1997; Kansitorn, Pooparadai and Smutkput, 2005). E-business includes online purchasing, and providing product and service information, which allow for cutting of costs, improving the quality of goods, and increasing the speed of service (Kleindl, 2000). The web provides a wide range of benefits including a relatively inexpensive means of accessing global markets, niche markets and low cost communication medium (Poon & Swatman, 1997; Kleindl, 2000).

Some major obstacles to e-commerce development by SMEs are lack of awareness, unsecured products ordering processes, unsecured payment systems, lack of an effective legal framework, poor telecommunication infrastructure, absence of a certification authority, internal impromptu and language problem (Wu, 2001). Developing an attractive web site is not enough to achieve success through e-business. To make it successful, collaboration is required with other individuals and institutions such as chambers of commerce, industry associations, and trade promotion organizations that can aggregate the offerings of their network, thereby branding them more effectively than the members can do individually (Salcedo, 2003).

### **Conclusion**

The SME sector is undoubtedly an important contributor to GDP and employment in India. Globalisation presents a set of opportunities and threats to the SME sector. However, for the sector to thrive and small and medium firms to gain competitive advantage, they need to focus on strategic issues such as institutional issues, strategic entrepreneurship development, innovation, social capital, cluster develop and e-commerce.

Though institutional issues in the form of government policy have till recently been tilted in favour of large firms, lately there has been a cognisance of issues related to SMEs, and these are being addressed through appropriate policy instruments. We argue that the government would have to continue to support SMEs through its policies, particularly, those pertaining to promotion of strategic entrepreneurial development, innovation, social capital, cluster development and e-commerce. These policies could include tax incentives, concessions, improved financing opportunities, access to markets, new technologies, innovation and technology transfer, among others.

Innovation forms the bedrock of SME success because it can help firms get access to resources, improve products and services, develop linkages and gain competitive advantage. Social capital, which includes the features of social organisation, has been recognised as a source of innovation and economic development. Clusters enable sharing of resources and information, and establishing coordination to achieve competitive advantage.

The strategic issues framework described in this paper would provide leads to researchers interested in establishing causal relationships of competitive advantage in SMEs. Since clusters are an important institutional arrangement of doing business, particularly in the SME sector in India, this paper presents an opportunity to researchers to study innovation, social capital and cluster development in SMEs.

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