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Should the MSMEs be Governed the Corporate Way?

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Abstract

This article makes a case for micro small and medium enterprises (MSME) governance as distinct from corporate governance even in instances where MSME firms are organised as bodies corporate. The credence for the suggestion for a separate framework for the governance of the MSME sector comes from (a) the contribution of the MSMEs to the economic and social development in their respective settings, (b) systemic nature of their ailments, (c) institutional and organisational contingency theory of corporate governance and (d) the theory of articulation (upward delegation) of decision making. The model of articulation of governance for the MSME sector (MAG_MSME) developed in the article provides for sharing of the costs and responsibility of governance by the participants in the articulation. Besides, it also addresses to the firm-level antecedents of governance and examines the roles of the entrepreneurs and their families in the MSME governance.

Keywords

Articulation of decision-making, contingency approach, corporate governance, governance, institutions, MSMEs, SMEs

Introduction

The prevalent discourse on the governance of MSMEs seems to be taking the corporate governance (CG) route. The article takes the position that since over 90 per cent of the MSMEs are in the proprietary sector and occupy the informal

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spaces within the economy, such an approach is grossly inadequate if not misplaced. Instead it makes a case for articulation of governance outside the firm—at the level of the clusters/industry associations and MSME facilitation and development agencies. The case draws its rationale and credence from the systemic nature of the problems faced by the MSME sector; the implications of the sector for macroeconomic and social indicators of development; and, the questionable justifiability of the trickle down of CG codes that even the large scale sector is finding hard to cope with.

The article does not investigate the question whether the MSMEs should be governed at all. In not doing so, it acknowledges the dual aspect of governance, namely, introducing a strategic change (Brunninge, Nordqvist & Wiklund 2007), minimising the downside risks of entrepreneurial performance and maximising the upside potential of the MSMEs (Filatotchev & Wright, 2005). What it says in effect is like this: governance is critical for the smaller firms too; however, the rights and responsibilities arising out of it may be contracted out via a process of upward delegation referred to as 'articulation of decision making' by Holesovsky (1977).

In drawing credence from the environmental and organisational contingencies impinging upon the MSME sector, the article also attempts to strengthen the contingency theory of CG (Aguilera, Filatotchev, Gospel, & Jackson, 2008; Huse, 2005; Uhlaner, Wright & Huse, 2007) that is still in its nascence. It develops a model that incorporates a constellation of firm-specific and institutional/environmental characteristics that permits articulation of rights and responsibilities of CG.

In the ensuing section, we take up for discussion the concept of governance as applicable to the MSME sector. We build a case for MSME governance on the basis of the sector's macroeconomic and social role, systemic nature of the problems that it faces and the non-tenability of the trickle-down concept of CG.

Corporate Governance and MSMEs

CG relates to the 'structure of rights and responsibilities among the parties with a stake in the firm' (Aoki, 2001). Effective CG implies mechanisms to ensure that the executives respect the rights and interests of company stakeholders, as well as guarantee that stakeholders act responsibly with regard to the protection, generation and distribution of wealth invested in the firm (Aguilera et al., 2008).

Essence of governance lies in the separation of decision taking from decision ratification and decision implementation from decision monitoring. Theoretically, the same person may perform these two distinct functionalities. However, practically what is envisaged is an independent agency that exercises ratification and monitoring oversight over the executive. What purpose such a distinction is likely to serve? The examination of the decision situation from diversity of perspectives is desirable to ensure that the enterprises serve their due roles in the national socio-economic context. MSMEs in India have been credited with the flowering of the spirit of innovation and entrepreneurship besides their quantitative role in GDP, employment generation, exports and the like. However, the sector is also besieged with higher incidences of informality, high mortality, poor quality and lack of competitiveness and environmental sustainability. The agenda of governance of the sector is loud and clear.

The issue is whether this agenda needs to be implemented at firm-level intervention or at broader levels of intervention. We posit that choice in this regard must be informed by the role that the MSME sector plays vis-à-vis the macro economic and social indicators of development. Besides, most of the problems that ail the MSME sector are systemic—be it availability of credit, inputs, industrial accommodation and market access. It may be well nigh impossible for the individual firms to address to these problems. Even if the MSME firms might be corporate in form, yet the substantive aspects of their smallness and larger than individual firm role of the sector, locus of governance in their case must lie outside the firm. We investigate these issues in the following paragraphs. Our focal point of analysis would be India's MSME sector, albeit it does not require detailed analysis to suggest that our observations can be generalised to virtually any MSME context.

MSMEs and Macroeconomic and Social Indicators of Development

MSMEs are defined differently in different contexts—on the basis of number of employees, output, value added, turnover, investment, nature of activity and combination criteria. However, the fact of a variety of definitions of MSMEs notwithstanding, the vast majority of businesses globally are very small (Di Giovanni, Levchenko & Rancière, 2010). Globally, the MSME can be shown to account for 52 per cent of private sector value added and 67 per cent of employment (ACCA, 2010). After the global melt down of 2008–2009, it has become commonplace to refer to this sector as the backbone of the world economy. The SME sector is highly dynamic. In 2002, the Global Entrepreneurship Monitor report suggested that as many as 460 million adults around the world might be engaged in an entrepreneurial activity—and that this might result in the creation of about 100 million new businesses (Reynolds, Bygrave, Autio, Cox & Hay, 2002). Business births are also a very substantial force in shaping the SME population, rarely falling below 3 per cent and rising to 19 per cent of the stock of businesses, depending on the structure and dynamism of different economies (ACCA, 2010).

Apart from static and dynamic contribution to the world economy, the MSMEs also contribute to the values and morals of the post crisis world economy. The popular discourse around SMEs often contrasts the sector with 'big business' and 'corporates', with the latter terms often used in a pejorative manner. What is often implied by commentators and policy-makers, but rarely made explicit, is that the wider public sees the SME sector, and particularly owner-managed businesses, as a force for good—the moral conscience of business. Indeed, Global research for the World Economic Forum has shown that the public believes SMEs in general to be more driven by universal values than are large corporates or national governments (Schwab, Zahidi, Rojas, Finnell, DeGioia & Banchoff, 2010). These values include, inter alia adoption of socially responsible practices as a direct result of their community ties (Bosma & Levie, 2010; Newberry, 2006), and self-employment opportunities and job satisfaction to the underprivileged or those likely to face discrimination (ACCA, 2010).

The global static, dynamic and moral expressions of the contributions of MSME sector reverberate even more loudly in India. In the static sense, MSMEs account for more that 75 per cent of the total factories, 45 per cent of India's manufacturing output, 40 per cent of India's workforce, 40 per cent of India's total exports and 17 per cent of India's GDP (Goyal, 2013). The dynamism of the sector is evident from the fact that business births as a percentage of stock of business during the last 5 years or so have ranged from 4.4 to 4.6 per cent. The sector derives its moral imperative from its potential to assure deliverance from poverty, creation of self-employment opportunities for and job satisfaction to socially marginalised strata of the society, namely, women and Dalits (socially and economically backward communities).

Systemic Nature of the Problems of the MSME Sector

One of the major systemic problems of the MSME sector is that globally a great deal of enterprise activity takes place not among 'formal' SMEs but in the informal economy. Informal businesses become inevitable in the wake of weak institutions and institutional voids (Autio & Fu, 2012). Infant mortality among businesses is also high. For instance, about half of the European businesses born in 2001 did not survive their first five years of operation (Scrör, 2008). In India, 79 small business units are turning financially unviable every day in the country. This translates to three units falling sick every hour. Financing is the biggest challenge and the lack of it is the main reason for an SME going out of business in India (Goyal, Gupta & Gupta, 2012).

In developed world, especially after the economic crisis, banks cut their lending to the SMEs and SMEs too curtailed their demand for credit during recession (Williams, 2012). SMEs in many developing countries have already been strongly restricted in accessing the capital, for example, only 20 per cent of African SMEs have a line of credit from a financial institution (Dalberg, 2011). When RBI recommends that there is a need to implement a CG code for the SME sector (Chakrabarty, 2012) it posits lack of governance as an impediment to the flow of credit to this sector.

On the demand side, post-1990s, many MSMEs, especially those engaged in the manufacture of consumer goods, lost their competitiveness and local markets due to inverted duty structures.

None of the problems stated herein may be said to be the making of the individual MSMEs; instead, these problems reflect the systemic inadequacies despite the fact that the most developmental agencies and the governments eulogise the sector's contributions.

Inadequacy of the Trickle-down Approach of Corporate Governance

Popularity of the concept of CG triggered the quest for the search of convergent and universal principles and practices of CG (Coffee, 1999). Much of the discourse follows agency theory. The underlying assumption is that corporations the world over are alike and conduct their operations under similar institutional settings. The approach of the policy makers, security trading regulators and corporate laws experts has been to extend the frameworks applied to publicly listed companies to privately held firms including those belonging to the MSME sector. In the process, they seem to be following the rule that if you are a corporation then you need to comply with CG codes (Liang & Meng, 2010). Such an approach has two implications. One, if you are not a corporation, then governance as understood in the sense of providing strategic direction, risk management and responsible management of the affairs of the firm does not matter. Two, if you are a corporation, then you have no option but to bear the cost of compliance on the assumption that all the governance-related problems of the corporation are of its own making and all the benefits of CG accrue only to the corporation. Clarke (2006) notes that while much of the corporate law and the CG rationale arose from the case of *Salomon versus A. Salomon*, a small, de facto one-man company, the subsequent discourse relegated the governance needs of the MSMEs.

The one-size-fits all approach has been questioned by the institutional theorists (e.g., Aoki, 2001; North, 1990; Rodrik, 2007) and contingency proponents/organisational theorists (e.g., Aguilera et al., 2008; Fligstein & Feeland, 1995). It has been noted that:

> No system [of corporate governance]…can be understood without first looking at the salient features of the particular society in which it developed. Everyone is to some extent imprisoned by their history, social, political, and economic. The way we think and the assumptions we bring to bear are not the product of an emotional spasm but the consequence of a long historical development which touches us throughout our lives without our understanding it. (Charkham, 1994, p. 1)

Farrar (1998) notes that CG regimes are normally drafted with larger listed public companies in mind and do not meet the needs of smaller companies. The cost of compliance with such regimes far exceeds the benefit. There is a need to cater expressly for the governance needs of smaller companies.

We take the position that governance of the MSMEs must also take the route of cluster-level, industry-association-level and meso- and macro-institution-level interventions. These interventions might take the form subsidising the costs of governance besides enabling and empowering the MSME sector (Levine, 2005).

Theoretical Framework

Two dominant theoretical perspectives this article draws on are (a) theory of articulation of decision making and (b) contingency theory of CG.

Theory of Articulation of Decision-making

Articulation of decision-making implies upward delegation (centralisation) of the power to make decision in respect of economic goods or services. This theory is rooted in the instances of market failures such as the cases of public goods and merit wants. Because in these cases, market mechanism would not be able to ensure the equilibrium between demand and supply, there is a need for centralisation of decision- making at some apex level.

We posit that the performance of the MSME sector is a public purpose, a desirable public good. Moreover, investment in the development of a policy framework and institutional apparatus for creating a favourable performance context is quite lumpy, beyond the capability of individuals. Hence, there is a need for contracting out via upward delegation (Holesovsky, 1977) of the responsibility for governance of the MSME sector to the other, larger stakeholders in its performance.

A question is often asked whether public investment in the performance of a private (MSME) sector is justified in the prevalent context of neoliberal macroeconomics and market-based approaches to economic development. A review of literature on this aspect shows that these approaches rather than ruling out the role of the state have emphasised the reorientation of public policy from protection towards the development of the MSME sector.

Accordingly, we modify Holesovsky's concept in relation to the prevalent market ethos and defend such an articulation on the grounds of efficiency and expedience. Disproportionately a large number of entrepreneurs are inadequately equipped and hence to expect them to be practising the governance chores developed for corporate enterprises would be impractical as well as undesirable. This is particularly important in view of the fact that due to the high costs of governance there already is a trend towards delisting if not de-corporatisation (*Economist*, 2012). *Business Standard* (2015) reported that in India 42 firms have delisted for similar reasons. If corporations are finding it difficult to cope with the costs of governance, it is not inconceivable to estimate the hardships of the already beleaguered MSME sector. What we propose is continued state support for the development of the sector as well as greater engagement of the partners in the value chain—be it the suppliers, the customers or the other stakeholders in the MSME cluster governance systems/industry associations. Of course, their respective roles will vary and the emergent architecture of MSME governance is likely to be enriched by this diversity in the manner board diversity enriches the governance of a large corporation. The difference is whereas costs of governance are internalised by the corporation in the large enterprise sector, in the MSME sector the same are largely externalised.

Contingency Theory of Corporate Governance

It is somewhat strange that an SME, named 'A Solomon & Co.', lies at the very edifice of the modern company law and Anglo Saxon theory of CG (Clarke, 2006), whereas much of the contemporary discourse on CG takes place in the context of large, listed and publicly traded corporations (Uhlaner et al., 2007). The *Salomon versus A Salomon* case solidified and codified the doctrine of corporate personality and the separation of ownership from management whether a company has a large number of shareholders or is, as in Salomon's case, a company managed and controlled by one person. Despite the fact that Salomon's case was based squarely on SME factual scenario, separation between owners and managers is a function of large, disparately owned firms, not MSMEs. Thus, the theory of CG for substantive purposes monotonously relies on the agency theory, you need CG so that the managers (the agents) subserve the interests of the disparate owners/shareholders (the principals). Clarke (2006) argues that the outcome of the principal–agent chain of logic is that even the CG term 'stakeholder' has been largely synonymous with the corporate law term 'shareholder', the difference between the two being a matter of emphasis on who the principal was/were. And the context is large, publicly held corporation, relegating the SME or MSME as the forgotten precedent of the modern company law and CG theories. It did not take long for the CG theorists to recognise the inadequacies of this straitjacket, one-size-fits all approach to the application of the concept in different contexts (Abor & Adjasi, 20007; Huse, 2005). Uhlaner et al. (2007) consider the influence of institutional context, the industrial sector within which the firm finds itself, the ownership context of the firm and the stage within the firm's life cycle. Jiang (2006) considers national legal and regulatory institutions, political institutions and institutional underdevelopment. Aguilera et al. (2008) focus on interdependencies between organisations and their environments.

Contingency theory of CG, thus, considers the influence of micro- (e.g., firm level), meso- (e.g., industry level) and macro- (national level) institutions on the CG structure, systems and processes. The case for the development of CG framework for the MSMEs arises here. The challenge for the development of such a framework however lies in the heterogeneous nature of the MSME sector across globe (Ayyagari, Beck, & Demirguc-Kunt, 2007). Indeed, the context dependence of both, the MSME sector and the CG practices reinforces the need for taking a contingency view of MSME governance.

MAG_MSME

Our model of articulation of governance for the MSMEs (MAG_MSME) rests on the premise that the goal of governance is and should be to harness the strengths and work on the weaknesses of the MSME sector in the broader socio-economic context of the respective settings. Thus, governance must stimulate, support and sustain MSMEs that serve as the nurseries of indigenous innovation and entrepreneurship. And it must address to the problems of sickness and sustainability, erosion of competitiveness and opaqueness of functioning on the other hand.

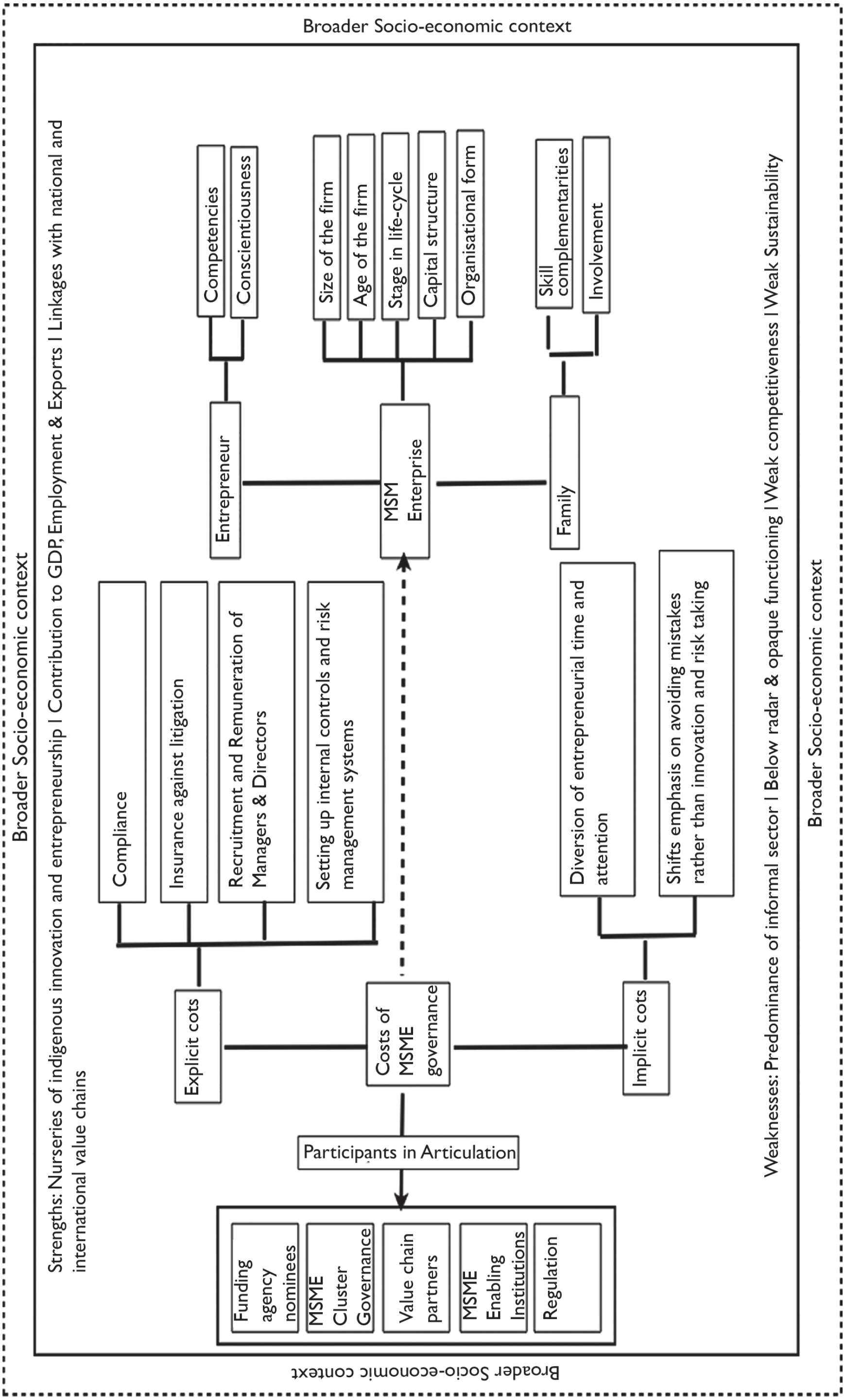

Figure 1. Model of Articulation of MSME Governance

Source: Authors.

Costs of MSME Governance

The model proposed in Figure 1 recognises the explicit and implicit costs of governance. The implicit costs of governance include the diversion of entrepreneurial time and focus from the imperatives of business. These costs also include shift in emphasis from innovation and risk taking. Explicit costs include that of compliance, litigation and remuneration to those engaged in governance.

Participants in Articulation

The model proposed in Figure 1 provides for the articulation of governance considered through funding agencies, clusters, value chain partners, enabling institutions and regulating agencies. It is pertinent to mention here that one may draw lessons from some of the existing practices in this regard. In certain industrial clusters such as Vatva (Gujarat), common effluent tratment plants are being successfully run that ensure the ecological sustainability of the MSMEs (Saxena, 2005). Likewise the quality-related issues are being addressed to and community level innovations taking place in such crafts and hand-woven products as Pashmina shawls (Sheikh, 2014). Banerjee (2005) notes that industrial clusters apart from fostering cooperation via common services and pooling of costs such as common effleuent treatment plants raise competitveness, innovativeness and strategic advantages of the firms. Accordingly, the model proposed herein makes a case for articulation of governance of the MSME sector outside the MSME firm. Table 1 captures the contours of the articulation of SME governance.

Table 1. Trajectories of Articulation of MSME Governance

Participants in the Articulation	Value addition to MSME Governance	Costs sharing potential
Funding Agency Nominees	'Finance plus' and 'Financial services approach'	Remuneration of the nominees, counsellors, directors or managers
Cluster-level Governance	Innovation, business incubation, common services	Costs of common facilities, quality assurance, compliance
Value Chain Partners	Co-value creation, assistance in technology upgradation	R&D
MSME Enabling Instittutions	Entrepreneurial capacity building, quality systems, marketing, accounting & auditing	Training & development, Branding & Marketing
Regulating Agencies	Transition from informal sector toward formal sector; managing sickness and business rehabilitation and exits	Industrial reconstruction, protection, frictional/ compliance costs associated with transition

Source: Authors' own.

In the model, MSMEs do not abdicate their responsibility for self-governance. What we posit is that a contingency approach to governance must consider the enterprise characteristics and those of the entrepreneur and the family such that it may be possible for the MSMEs to avail of the benefits of governance while selectively incurring the costs of governance.

The Triology of Enterprise Level Governance

MSM Enterprise

There is some research evidence on the impact of firm level contingencies such as age of the enterprise, size (proxied by board size) and stage in the life cycle on CG (e.g., Dalton, Daily, Johnson & Ellstrand, 1999; Filatotchev & Toms, 2003; Filatotchev & Wright, 2005). Interpreting the extant research in the context of MSMEs, it is not difficult to envisage that the ability of the MSME to absorb the costs of governance would depend upon its age, size and the stage in the life cycle of the firm. Younger, fledgling enterprises can hardly afford to spread their resources too thinly. Likewise it may not be possible for the enterprises on the decline stage of the life cycle to bear the costs of governance. If the enterprise is majorly funded by the own resources of the entrepreneur, the need for CG in the context of agency theory hardly arises. The propreitary forms that abound in the case of such enterprises rule out the 'corporate' way of governance by definition. However, to the extent that these firms may be funded by private equity, institutional finance, venture capital, angel investors, crowd funding, etc., the performance of the governance functions at the end of these investors could ease the stress off the MSME enterprise and the entrepreneur. The idea of 'finance plus' and the paradigm of financial services (Levine, 1997) point to the possibility of contribution of the these actors to the governance of the small firms.

Enterprenuer

In a small enterprise, entrepreneur is the biggest source of human capital and the fountainhead of all governance so much so that firm is regarded as an instituionalised extension of persoanlity of the entrepreneur (Casson, 1996). It is the ability of the entrepreneur to negotiate role and goal succession as their organisations undergo successive stages in evolution and revolution (Greiner, 1972). It is on the entrepreneur to learn from the linkages the firms has with the external stakeholders and leverage these for the benefit of the firm and its role in the larger socio-economic domain. We consider entrepreneurial competencies and conscientiousness as the key determinants of the quality of governance in a small enterprise without invoking the costs of instituting a formal governance system. Given that the governance of MSMEs is aimed at mainstreaming of the informal sector, improvement in the quality of its products and enhancing its access to credit, resources and national and international value chains for sustainable competitiveness (Srivastava & Rahu, 2010), the role of competencies and conscientiousness of the entrepreneur can hardly be exaggerated.

Family

Family and family involvement in business as a source of social capital (Annen, 2001), resource and competence complimentarities (Barney, 1991) has a bearing on the efficacy of the MSME entrepreneurs to institute governance mechanisms and practices. However, the entrepreneur has to guard against the possible fallouts of too much involvement, namely, opaqueness, cronyism and the imact of family squabbles on succession and the firm ecosystem. Tagiuri and Davis (1996) explore bivalent effects of family on the firm (CG). Saxena (2013) has examined governance risks associated with family controlled business groups.

Conclusions

The trilogy at the firm level, namely, MSM enterprise characteristics, the entrepreneur and the family and the pentalogy at the articulation level, namely, the funding agencies, the cluster governance, the value chain partners, MSME enabling institutions and regulation comprise the core of the SME governance model proposed in this article. The model in turn draws from the theories of articulation of decision-making (Holesovsky, 1977) and context based, contingency approach to decision-making (Aguilera et al., 2008; Huse, 2005; Jiang, 2006; Uhlaner et al., 2007) to emhasise the point that MSMEs need not be governed the corporate way.

The article makes a case for sharing of the explicit costs of governance by the participants in articulation. In doing so, it proposes greater stakeholder engagement for reinforcing the role the MSME sector plays in the economy. This has implications for the need for state protection and regulation of MSMEs despite the emerging ethos of neoliberal, market-oriented macroeconomic management. Equally importantly, it emphasises a collaborative approach to governance as against the extant models that presume conflict among the stakeholders.

It also points to the goal and role succession that the entrepreneur has to traverse from entrepreneurial role in the start-up stage, managerial and leadership roles in the growth stage to the governance role towards MSME transition into a large scale entity. The article also underlines the role of family involvement and family and community social capital where family and community resource and competence complimentarities might have useful implications for the governance of the firms. The article reitereates that the responsibility for governance cannot be abdicated; however, it may be usefully shared given the peculiarites of the MSME sector in specific settings.

The article is propositional. Given the acceptance of the proposed model, further research in the area may empirically evaluate the extent of articulation of SME governance in different institutional settings with a way to harnessing the potential of this sector in the respective economies.

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