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INNOVATION CAPABILITY, ABSORPTIVE CAPACITY AND SMES PERFORMANCE IN PAKISTAN: THE MODERATING EFFECT OF BUSINESS STRATEGY

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ABSTRACT

The small and medium-sized enterprises (SMEs) play a crucial part in county's economic growth and a key contributor in country's GDP. In Pakistan SMEs hold about 90 percent of the total businesses. The performance of SMEs depends upon many factors. The main aim for the research is to examine the relationship between Innovation Capability, Absorptive Capacity and Performance of SMEs in Pakistan. This conceptual paper also extends to the vague revelation on Business Strategy in which act as a moderator between Innovation Capability, Absorptive Capacity and SMEs Performance. Conclusively, this study proposes a new research directions and hypotheses development to examine the relationship among the variables in Pakistan's SMEs context.

Keywords: Innovation capability, absorptive capacity, business strategy and performance of SMEs

INTRODUCTION

SMEs are considered as one of the main pillar in county's economic growth and a key contributor in country's GDP. In the emerging economies, SMEs are the major contributor to the national economic development and also a major source of the employment generation (Irfan, Kee, Qureshi, & Hussain, 2014). Generally It is a viewed that the large firm contributes more to the economic development and foreign exchange earnings but now this point of view has been changed because countries like Japan, Korea, and Taiwan has developed their economies by Small and Medium Enterprises businesses (Ali Shah,

Mehmood, Aamir Hashmi, Maqsood Shah, & Muhammad Shaikh, 2011). Arinaitwe, (2006) stated that, Despite generous contribution and economic support towards development, it is acknowledged that SMEs performance remains below the expectation level among developing countries. The low level of SMEs performance contributing factors comprise of critical economic conditions, poor infrastructure support, inconsistent public policies, financial constraints, high operating cost and corruption (Ogbo & Nwachukwu, 2012; Sunny , Ifeanyi, & Sunny, 2015). Researcher, scholar, and practitioners underlined well about the significance and importance of SMEs, but still studies argued some significant weaknesses that exist with SMEs and their performance relationship.

Various studies indented many constraints and barriers for the SMEs performance (Shah, Othman, & Mansor, 2016). There is no doubt that SMEs are the key contributor towards the economic development of each country. However, the SMEs collapse ratio is still very high and alarming situation for developing, emerging as well as developed countries. Past studies acknowledged that within the five years of the business operation, significant numbers of new SMEs fails in this duration (Kuratko, 2005; Mbonyane & Ladzani, 2011). Several studies from Australia, USA and England exposed that approximately 80% to 90% failure of SMEs within 5-10 years (Ghobakhloo, Hong, Sabouri, & Zulkifli, 2012; Kuratko, 2005). However, Pakistani SMEs failure rate is approximately 90-95% at initial stages (Ullah, Dean, & Kaleem, 2011).

The SME performance of the developing countries remains at a lower level compared to the developed countries (ASIAN Development Bank Institute, 2015; Ihtasham ul Haque, 2016; IMF, 2016). So, for most of SMEs in developing countries context have facing critical issues of low level of performance because it is expected that SMEs play a significance part for economic development. Planning, Development and Reform Minister of Pakistan Ahsan Iqbal has insisted the World Trade Organization (WTO) to sustenance Pakistan in the progressive development of SME sector. He stated that Pakistan's economic progression depends upon the growth of SMEs (Daily Times, 2016). From continues three years in a row, Pakistan missed the projected GDP (Pakistan Economic Survey, 2016). The GDP growth of Pakistan is slow as compared to some other ASIAN countries.

LITERATURE REVIEW

SMEs Performance

Organizational success is generally denoted by the term firm performance. It is measured as the achievement of expected organizational outcomes such as goals and objectives. The performance is defined as "The comparison of the value created by a firm with the value owners expected to receive from the firm" (Alchian & Damsetz, 1972). Another explanation of the construct viewed it as "The way organization carries its objectives into effect" (Flapper et al., 1996). Firm performance is measured as an actual output of a firm against its input. Performance measurement enables organizations to emphasis on units that need enhancement by assessing the work progress level in terms of cost, time and quality along with associating in capacities by greater output (Tomlinson, 2010). Ireland, Hitt, and Sirmon, (2003) revealed that the concept of performance measurement is largely ill understood and misconceived by SMEs which usually fail to envision the potential merits of developing and implement a performance measurement program. It was further added that SMEs perceive the implementation of performance measurement programs as a step forward towards

bureaucratization and to limit the extent of flexibility in SMEs (Hvolby & Thorstenson, 2000).

Innovation Capability

Innovation capability is the vital motive of organizations for doing innovation in order to get organizational success. Saunila et al. (2013) stated that innovation capabilities vary from firm to firm and it also varies by type of innovation and various effective factors. As postulated by Perdomo-Ortiz, (2006), on the basis of RBV and Dynamic capabilities perspective, "to innovate, a firm requires the capability for innovation". Saunila, Ukko and Rantanen (2012) and Yang, Lee, and Lin (2012) acknowledged that innovation capability help the firms to gain higher performance and sustainable competitive advantage. Tidd, Bessant, and Pavitt (2001) stressed that the firms which has better innovation capability are resulting double sales profits in accordance to the firm with less or no innovation capability. For that reason, Hurley and Hult (1998) stated that innovation capability is fundamental element for the constant growth and its sustainability.

Several research studies among innovation capability and SMEs performance linkage are done in developed countries like Canada (Bommer & Jalajas, 2002; Ifinedo, 2011; Snider, Silveira, & Balakrishnan, 2009), United States of America (Bommer & Jalajas, 2002; Snider et al., 2009; Wolff & Pett, 2006), Netherlands (de Jong & Vermeulen, 2006; Wolff & Pett, 2006), England (Hippel, de Jong, & Flowers, 2012), New Zealand (Clark, 2010), Europe (Parida, Westerberg, & Frishammar, 2012) and Turkey (Murat & Baki, 2011). In the developing nation, policymakers considered the findings while designing the policy measures, But the formulated theoretical models in the developed countries context cannot be implemented or replicated in the developing countries SMEs context (Haroon Hafeez, Noor Mohd Shariff, & Lazim, 2013).

To conclude, with reference to empirical research, despite of some conflicting evidences (Kimberly & Evanisko, 1981; Darroch, 2005; Rogers, 2003), majority of the studies have shown the significance positive relationship between innovation with firm performance (Agyapong & Acquaah, 1991; Annavarjula et al., 2012; Purwanto & Raihan, 2016; Sepúlveda & Vasquez, 2014).

Absorptive Capacity

The concept first developed as significant in the 1980s, with the, acquisition and application of new knowledge as the fundamental role in business competitiveness. The contribution made by Cohen and Levinthal (1990, p.128) is largely acknowledged as the founding paper. They define absorptive capacity as "the ability of a firm to recognize the value of new external information, assimilate it, and apply it to commercial ends". More ever Zahra and George (2002), re-conceptualized absorptive capacity as "a set of organizational routines and processes". Zahra and George (2002) provide an overall model that considers absorptive capabilities as a dynamic construct.

Fosfuri and Tribo (2008) acknowledged that absorptive capacity in a knowledge based economy is considered as a crucial dynamic resource or capability. Nowak, (2013) stated that absorptive capacity is a key driver for firm's competitiveness. In previous researches, the absorptive capacity was examined in many of performance models, and most of them acknowledge or proved significance positive relationship with firm performance(Chen, Lin, & Chang, 2009; Nagati & Rebolledo, 2012; Zahra & George, 2002; Ali, Seny Kan, &

Sarstedt, 2016; Ben & Greve, 2012; H.Nagati, 2012; Herath & Mahmood, 2014; Liao, Liu, & Wang, 2012; Tzokas, Kim, Akbar, & Al-Dajani, 2015; Wang & Han, 2011).

Regardless, there are some studies which have insignificant, week and Mixed findings between absorptive capacity and performance (2010 Wales, Parida, & Patel, 2013; Ali & Park, 2016; Schildt, Keil, & Maula, 2012; Lichtenthaler, 2016). Few studies focuses absorptive capacity in the context of SMEs (Becheikh, 2013; Filippini et al., 2010; Guo & Wang, 2014; Herath & Mahmood, 2014; Kamal & Flanagan, 2012; Tzokas et al., 2015). In the SME performance models, the role of absorptive capacity has more to be clarified (Herath & Mahmood, 2014).

Business Strategy

Strategy matters because it provides precise directions to a firm. The impact of business strategy on organizational performance is a very important subject, in the face of increased globalization and fierce market competition. Now in a days of globalization and high competition, the impact of a business strategy on firm performance becomes a very important matter. Strategy is directly linked to the firm performance because it provides the means and directions for the firms that how to achieved high performance (Gibcus & Kemp, 2003). SMEs should focus on implementing business strategy diversity rather than to concentrate on single strategy because it make easier for firm performance measurement (Olson & Bokor, 1995).

Competitive advantage is critical in order for a firm to perform above average within a given industry. It indictes that firms are able to produce a value that is seen higher than its competitors. Porter (1980) states that Business strategy (competitive strategy) enables a firm to defend itself in a given industry. A strategy, therefore, should be based on a firm's unique and individual advantages, capabilities, and circumstances. Organizational performance depends on the business strategy adopted and implemented (Blackburn, Hart, & Wainwright, 2013). Findings by some researchers has also established links between business strategy and firm performance (Anwar & Hasnu, 2017; Anwar, Shah, & Hasnu, 2016; Yuliansyah, Gurd, & Mohamed, 2017).

There are several research conducted which tested the theoretically and empirically the relationship between strategy and performance, i.e. in Taiwan (Chen, 1999), in Malaysia (Ho, Ahmad, & Ramayah, 2016), and in several countries of Europe and USA (Abimbola, 2001; Simpson, Taylor, & Barker, 2004; Guarda, Santos, Pinto, Augusto, & Silva, 2013; Parnell, Lester, Long, & Ali, 2014). Nevertheless, countries like Pakistan have some scarcity regarding research, especially in SMEs of Pakistan.

Rationalize of Business Strategy as a Moderator

In the generic management literature the idea about the effect of business strategy on firm performance prevalent significantly. Business strategy signifies a process that changes the influence or impact of independent variables on firm performance regarding the context of RBV (Amoako-Gympah & Acquaah, 2008). This variable can be regarding as potential variable along moderating effect (Chan, He, Chan, & Wang, 2012; Kim & Huh, 2015; Vidija, Obonyo, & Ogutu, 2016). Study conducted by Mcgee, Dowling, & Megginson, (1995), in which the moderating role of Business strategy was examined between corporate stagey and new venture performance among the 210 manufacturing companies. The result shows that Business strategy moderates the relationship between corporate strategy and business

performance. Vidija et al., (2016) attempted to build up a moderating effect of competitive strategy between employee outcomes and firm performance of listed companies in Nairobi-Kenya. The questionnaire was distributed among 60 firms. The result shows that the employee outcomes and performance relationship is moderated by Competitive strategy positively. Su et al. (2017) attempted to investigate the moderating effect of business strategy (including differentiation and cost-leadership strategies) to the association among exploration and firm performance. The data was gathered from 273 Chinese firm and the results shows that differentiation strategy moderates the association between exploration and firm performance while cost leadership did not moderated the relationship.

PROPOSED CONCEPTUAL FRAMEWORK

The resource based view (RBV) posited that the unique resources of a firm generate competitive advantages (Wernerfelt, 1984; Barney, 1991; Peteraf, 1993). As, the RBV emphasized on firms' distinct bundle of resources, of the firm focuses on a firm's unique set of resources, it is crucial for growth and survival of small firms to identify those critical resources. The RBV of the firm presents a framework for small firms to strategize based on those critical resources that can enable the firm to gain sustainable competitive advantage (Peteraf, 1993). RBV indicates that firms are continuously increasing resources and capabilities while rival firms are continuously imitating and improving their resources and capabilities. Innovation capabilities' concept originated in the theory of organizational capability and is considered as a new notion that matches the RBV of the firm, where the RBV posits that firms optimally exploit their resources (Slater, Mohr, & Sengupta, 2014). In this scenario, innovative capability refers to the firm's ability to innovate from a RBV at the firm level ((Nada & Ali, 2015). In line with the absorption capacity model, the literature under RBV theory considers absorptive capacity as strategic capability as it is a path-dependent, firm-specific, and a socially embedded way of using other firm's knowledge to create competitive advantage primarily from an external perspective (Nagati & Rebolledo, 2012). As the literature has revealed the inconsistent association between Innovation capability – performance linkage and Absorptive capacity – performance linkage. Hence business strategy satisfies the criteria for selection as a moderator (Baron & Kenny, 1986). Therefore this study is examining the moderating effects of business strategy on innovation capability, absorptive capacity and SMEs performance.Below is the framework as mentioned above:

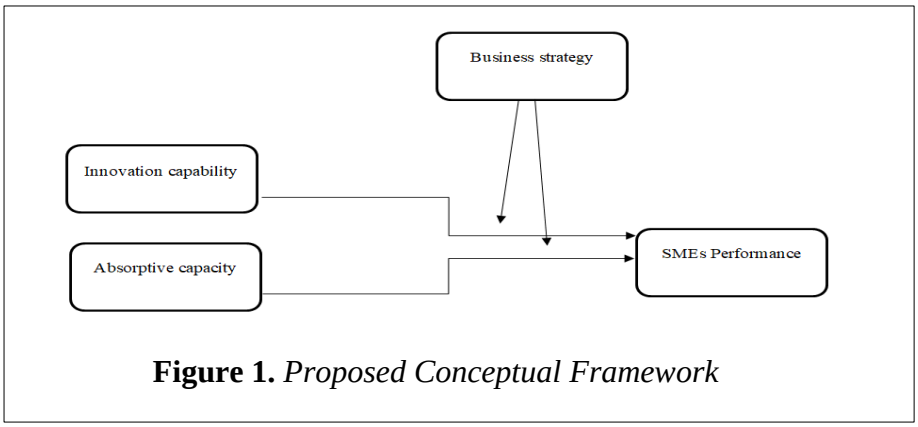

Figure 1. *Proposed Conceptual Framework*

RESEARCH PROPOSITION

The following hypotheses are proposed:

H1: Innovation capability has a significant effect on performance of SMEs
H2: Absorptive capacity has a significant effect on performance of SMEs.
H3: Business strategy moderates the relationship between innovation capability, absorptive capacity and performance of SMEs.

CONCLUSION AND RECOMMENDATION

A review of prior literature indicates that two organizational capability i.e. innovation capability and absorptive capacity have a significant effect on the SMEs performance. The proposed research framework further posits that business strategy moderated the relationship between innovation capability, absorptive capacity and performance of SMEs. This conceptual paper employs the RBV theory to support this framework. The direction for future research should be to empirically test to what extent and how innovation capability, absorptive capacity and business strategy are related and impacting SMEs performance in the emerging economy like Pakistan. If the framework empirically validated, the finding will offer an important insight to academics, policymakers and practitioners into the significant effect of innovation capability, absorptive capacity, business strategy and performance of SMEs in Pakistan.

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