Relational Contract, Asset Specificity and Business Performance: An Empirical Investigation of Small Enterprises in Seethawaka Divisional Secretariat Division in Colombo District, Sri Lanka

APM Jayathilake and HMS Priyanath

Department of Economics and Statistics, Faculty of Social Sciences and Languages, Sabaragamuwa University of Sri Lanka, Belihuolya, Sri Lanka

ABSTRACT

This study explores the effect of relational contracts on asset specificity and business performance of Small Enterprises (SEs) in Sri Lanka. The study used primary data gathered from 197 SEs in Seethawaka Divisional Secretariat Division in Colombo District using a structured questionnaire survey. Partial Least Square - Structural Equation Modelling was used to analyze the data. Empirical results show that relational qualities positively influence business performance and asset specificity. Further, asset specificity and business performance have a positive association. Also, asset specificity acts as a mediator by improving the relationship between relational contract and business performance. Therefore, the business performance of SEs can be enhanced by organizing network formation programs such as seminars and conferences to create strong relationships with exchange parties that encourage asset specificity.

Keywords: Asset Specificity, Business Performance, Relational Contract, Small Enterprises

© Faculty of Management Studies Sabaragamuwa University of Sri Lanka

INTRODUCTION

Small Enterprises (SEs) are an important vast developing sector and considered as the backbone of an economy (Prasad et al., 2012). They support enhancing the national production, increase the exports earnings, innovations, generate job opportunities, reducing the poverty, and contributing to income generation of the economy (Prasad et al., 2012). Hence SEs are important for developing an economy. Petkovic et al. (2016) stated that more than half of new SEs fail during the first year. Yeboah (2015) explained that at the beginning of the first year, only 30% of new small businesses began to fail: during the first two years 50% and also during the first ten years, 66%. Even in Sri Lanka, the government provides different types of assistance to develop SEs, but the sector has not shown satisfactory performance (Priyanath & Premaratna, 2014). Meanwhile, some scholars (Carmel & Nicholson, 2005; Jagwem, 2011; Nooteboom, 1993) highlighted that SEs have a higher failure rate due to the limitations mostly replicated in Transaction Costs (TC). The TC leads to discrimination against SEs, damaging their survival and success (Carmel & Nicholson, 2005).

TC is simply the costs of carrying out any exchange, whether between firms in a marketplace or a transfer of resources between stages in a vertically integrated firm (Hobbs, 1996). Williamson (1985) proposed that the TC is based on two human factors (bounded rationality and opportunism) and two environmental factors (uncertainty and asset specificity). Asset specificity refers to the investments an exchange partner makes that are highly specialized and can be redeployed only by sacrificing productive value. Williamson (1979) explained two types of transaction cost governance structures i.e. 'Market' (use open market to purchase inputs and sale outputs) or 'Hierarchy' (internalize transactions within the firm hierarchy or integrating firms). The hierarchy among firms is known as vertical integration, where the transaction is removed from the market and organized among the firms subject to a specific relation (Williamson, 1979, 1981; Zhang, 2009).

SEs have regular connection with of exchange partners (both different buyers and suppliers), and these vertical connections increase the levels of trust, norms, flexibility, mutuality, common understand among the exchange partners of the network (Bhagavatula, 2009; Bolino et al., 2002: Priynath, 2017). Vertical network relationship provides perfect information, which can quickly be transformed into successful opportunities (Uzzi, 1997). Scholars highlighted

that vertical network relationship has an impact on business performance since the such relationship leads to share knowledge and exchange information and their impact on innovation and business performance (Tsai, 2001; Lu, 2007; Priynath, 2017). Long-term network relationship is governed by Relational Contract (RC) which captures how buyers and suppliers manage their relationships and continue their interactions in order to develop self-enforcing safeguards (Heide & John, 1990). The relational contract is defined by a set of informal norms that affect the behavior of parties when they deal with each other (Macneil, 1985). The use of relational forms of governance is commonly cited in the literature as a viable and efficient method to successfully govern and safeguard inter-organizational relationships which lead to avoid opportunistic behavior of exchange partners and encourage assets specific investment (Poppo & Zenger, 2002). Asset-specific investment can be expressed as a specific transaction investment that one cannot transfer counterparties in a specific transaction without destroying productivity (Buvik & Andersen, 2002). Noordeweir et al. (1990) explained that increasing the RC of exchange can act to encourage cooperation between exchange partners and thereby encourage transaction-specific investment discouraging opportunistic behavior of exchange partners. Thus, RC act as an effective safeguard for specific assets by moderating the opportunism associated with those assets and improve business performance (Rokkan et al., 2003). However, in the literature, no sufficient empirical evidence available to identify, how RC integrates with exchange parties investing in transaction-specific assets and how RC affects the business performance, especially in SEs in Sri Lanka? Therefore, this study aims to explore empirically the effect of RC on asset specificity and business performance of SEs in Sri Lanka.

The study contributes to the knowledge providing empirical evidence on the effect of RC on asset specificity and business performance of SEs. It will further extend the knowledge about the mediating role of transaction-specific assets on the relationship between RC and business performance. The empirical findings of this study will contribute to the policymakers developing alternative policies to achieve the fast growth of SEs on the one hand and will facilitate SEs to achieve their business success on the other hand. The article adopts the following outline to accomplish this goal. The next part integrates the literature review and synthesizes the research model. Subsequently, the material and methods are described, and the empirical findings are discussed. Finally, the study presents the conclusion and potential directions for future research.

THOERETICAL BACKGROUND

Relational Contract (RC) Theory

The theory of RC was developed by Macneil in 1983. According to Macneil (1983), RC can be identified as a contract whose effect bases on a relationship of parties depend on the trust to which it pertains. According to Baker, Gibbons & Murphy (2002), RC can be considered as informal agreements stated by famous considerations are being both with and between enterprises. RC captures how buyers and suppliers manage their relationships and continue their interactions in order to develop self-enforcing safeguards (Heide & John, 1990) and are defined by a set of informal norms that affect the behavior of parties when they deal with each other (Baker et al., 2002). The RC focuses on the behavioral assets of the network and the strength of relationship developed by a business firm with its exchange partners in its network and personal relationships that the business firm develops with each other through a history of interactions are the two main features of RC (Silkoset, 2013). The RC is considered as the valve of inter-personal relationships i.e., high levels of trust, relational norms and obligations, and a sense of mutual identification developed through regular interactions (Bolino et al., 2002). Hence, RC contains two dimensions such as relational qualities and strength of ties. According to that, the relational value depends on the strength of the relationship and the qualities of the relationship. Relational qualities are reflected by interpersonal trust and norms (reciprocity, flexibility, solidarity, and the role of integrity (Dyer & Chu, 2003; Rokkan et al., 2003). According to Macneil (1985), contractual behavior norms are role integrity, reciprocity, flexibility, contractual solidarity, reliance and expectations, restraint of power, the propriety of means, and harmonization of conflict.

Asset Specificity

Williamson (1981) managed the concept of asset specificity which is more important to describe the transaction cost. According to Williamson (1985), Transaction Cost Theory (TCT) has become one of the most significant and most used theories for analyzing the various types of inter-firm relationships. TCT has key assumptions about human behavior and environmental characteristics (Williamson, 1979; 1985). However, under assumptions of environmental characteristics, it has included three assumptions such as asset specificity, uncertainty, and frequency of the transactions.

Concerning these assumptions, asset specificity is a more important environmental characteristic of TCT. Williamson (1985) defined asset specificity as the stable investment that is supported to specific transactions, the opportunity cost of that investment too lower in uses of best alternatives. Asset specificity can be expressed as specific transaction investment, regardless of contract type in an increase of transaction cost (Williamson, 1981). Further, asset specificity presents that one cannot transfer counterparties in a specific transaction without destroying productivity (Buvik & Andersen, 2002). Williamson (1981) stated that asset specificity consists of several types such as site-specificity, physical asset specificity, human asset specificity, temporal specificity, and brand name specificity. As well, site (locational), human resources, special product or service (physical assets), dedicated assets, brand, and temporal specificity are involved in the transaction, which depends between the exchange partners under the asset specificity (Williamson, 1979; 1985). Further, Gersch (2011) stated that generally six types of asset specificity as site-specificity, physical asset specificity, human asset specificity, dedicated assets, brand capital, and temporal asset specificity.

Business Performance

It significantly affects business organizations to reach their organizational goals and objectives. Today in the economic environment measuring business performance has become a critical issue for practicing managers and academic scholars. Business performance is the operational skills to satisfy the desire of the firm's certain stakeholders and also it should be evaluated to measure a business firm's goals (Smith & Reece, 1999). And also business performance must be aimed to achieve organizational goals by measuring success or failure. Further, business performance acts as a model which examines the indicators such as profitability, earning per share, improvement in sales, and also onward (Venkatraman & Ramanujam, 1986). However, business performance is a successful complement of strategic targets with the assist of commercial business enterprises (Indris & Promina, 2015).

Many scholars have identified different dimensions under the concept of business performance. Hence, it can be measure in different ways such as subjective or objective and financial or non-financial. Moers (2000) stated that financial measures consider a short period for entire business performance and non-monetary measures consider a long period for business enterprises. Zahra (1993) stated that both measures of financial and non-financial should be

referred to evaluate the firms' performance. According to Rizal, Suhadak & Kholid (2017) noted the growth of sales, profit, income, employment, return to investment, and market share refers to measure business performance. Richard et al., (2009) found that profit, income, returns on investments, returns on equity, sales growth, returns on sales, and profitability which are included in the financial performance and customer satisfaction, employee satisfaction, owner's satisfaction, customer loyalty, brand awareness, competitors, employment of additional employees are the ways which consist under the non-financial measures. However, workers, machinery and equipment, land, building, the volume of products, transport equipment, and customers are used as items to evaluate the nonfinancial performance (Miththrananda & Priyanath, 2020).

Hypotheses

This study evaluates the strength of RC on asset specificity (AS) and the business performance (BP) of small enterprises. And in this study, the independent variable is a relational contract, the dependent variable is business performance and asset specificity are the mediate variable as shown in Figure 1.
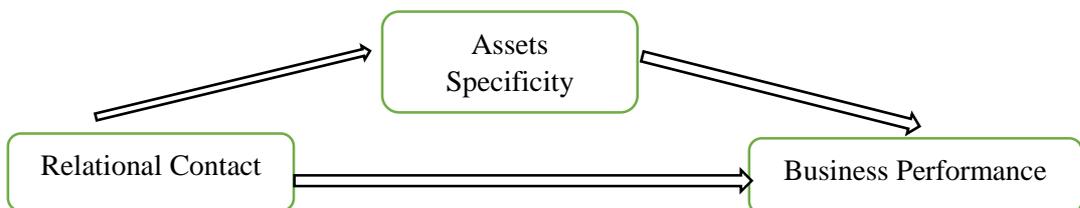
Figure 1: Conceptual Framework

Strength of Ties and Business Performance

According to Todo et al. (2016) supply chain networks affect the growth of productivity and innovation capability of business enterprises. Hence can be identified the strength of ties positively affect improve the performance of business enterprises. According to Uesugi (2015) supply chain, ties, and the development of new intermediate have a positive relationship. Flynn et al. (2010) found that the strength of relations with customers has a positive impact

on the performance of business enterprises. Each partner has greater knowledge about the other's resources and greater confidence in their mutual assessments, business risk is disappeared (Gulati & Sing, 1998). SEs can search and contact reliable exchange partners by information access through bridging and linking ties. SEs can search through their network whether they have selected the right exchange partner to carry out the transaction (Gulati & Sing, 1998). Thus, relational ties can be used to reduce the potential risk of opportunistic behavior of exchange partners with leads to business performance (Carey & Lawson, 2011). Rost (2011) emphasized that networks among investors of the German automobile industry with strong ties collaborators regularly develop innovation. It was implied that strong ties affect improves the firm's performance. Geyskens et al. (2006) also has explained relational ties largely affect improve the firm's performance. Thus, can be identified that the strength of ties and business performance of SEs has a positive relationship. Therefore, based on the above findings this study hypothesis that;

H1: Strength of ties has a positive impact on the business performance of small enterprises.

Relational Qualities and Business Performance

According to Ivens (2004) relational quality becomes a central attribute of long-term business performance. Gamage and Priyanath (2019) stated that many scholars indicate relational norms like collaboration, trust, information sharing, loyalty, etc. assist in the improvement of business performance. There is a positive association between norms and business performance since it affects reducing the riskiness of business enterprises when exchange dealers share their common goals. Samouel (2007) emphasized that relational norms permission business dealers to long-term grew business relationships proofing the positive effect between norms and business performance. Relational norms and business performance have a positive correlation (Heide & John, 1992). Siguaw et al. (1998) stated that relational norms affect success the better relationship behaviors and affect to enhance the alliance performance with financial performance. According to Priyanath et al. (2016a; 2016b), relational norms have the power to manage the exchange relationship between partners to improve business performance. Thus, can be identified relational qualities and business performance of SEs have a positive relationship. Therefore, based on the above findings this study hypothesis that;

H2: Relational qualities have a positive impact on the business performance of small enterprises.

Strength of Ties and Asset Specificity

According to Gerdoci et al. (2016) strength of relational ties affect to reduce the transaction cost and affect to improve asset specificity. However, Lui et al. (2009) stated that relational exchange suggests more cooperative behavior that represents trust between parties' effect to enhance the asset specificity. Zhao and Wang (2011) found that relational-specific investment on channel relationship performance and enhance the social ties. Strength of ties helps SEs to invest assets specificity without having legal contact because the firm can observe the trustworthiness of each other which leads to saving contact cost and accelerating the firm's performance (Tsai & Ghoshal, 1998). Lu et al. (2012) explained that the strength of ties causes the decrease of transaction cost with promoting assets specificity. Assets specificity promotes recurrent transactions and such a relationship increases the commitment between partners and promotes RC which helps to minimize documentation and legal costs and increase performance (Lu et al., 2012). Dyer and Chu (2003) highlighted that business firms can achieve twin benefits of high asset specificity and low cost with higher collaboration. Moreover, the strength of ties, in turn, generates trust between them which encourages firms to invest in assets specific productions (Lu et al., 2012). Thus, can be identified the strength of ties and asset specificity of SEs has a positive relationship. Therefore, this study hypothesis that;

H3: Strength of ties has a positive impact on asset specificity of small enterprises.

Relational Qualities and Asset Specificity

Strong ties among exchange partners develop a mutual understanding that encourages asset specificity. SEs are empowered to enter into verbal, informal, handshake deals and commit their firm to transactions that are governed by norms of reciprocity that promote asset specificity (Gedajlovic et al., 2016). According to Mithas et al. (2008), they recognized how non-contractibility such as quality, information exchange, responsibility, supplier technological investments, flexibility and trust affect the asset specificity of business enterprises. Malone et al., (1987) stated that as a result of the interaction of exchange parties, asset specificity can be raised. Williamson

(1985) found that asset specificity increases with the improvement of the relationship of exchange partners. According to Anderson and Weitz (1992), specific asset deployment has a strong positive impact on the relationship of both parties to the commitment. When exchange parties invest in specific assets, reciprocity is governed by a hostage discovery that enforces the compliance to the association (Williamson, 1981). Thus, can be identified relational qualities and asset specificity of SEs have a positive relationship. Therefore, this study hypothesis that;

H4: Relational qualities have a positive impact on the asset specificity of small enterprises.

Asset Specificity and Business Performance

According to Mang (1998) investment in transaction-specific assets assist to decrease the cost of the firm and it helps to growth of the business performance. Chandler et al. (2009) stated that, the positive mediate relationship of asset specificity with sales growth and employment growth. Buvik and Reve (2001) stated that, employs specific assets have a valuable relationship with the relationship of buyer and seller. Asset specificity proves the presence of a contractual formality relationship with business performance (Ambrozini & Martinelli, 2017). According to these scholars, asset specificity affects the growth of business performance. And he indicated that asset specificity affects a higher level of profitability operation in the business firm. Thus, can be identified as asset specificity and business performance of SEs have a positive relationship. Therefore, this study hypothesis that;

H5: Asset specificity has a positive impact on the business performance of small enterprises.

Mediating Effect of Asset Specificity

If parties expect the possibilities of future obstacles, they have to incentive to build the specific investment. Hence, integration between exchange parties leads to firms' performance to protect specific investment and it can become an efficient argument for contractual incompleteness (Williamson, 1985). RC of suppliers and buyers with an integrated effect to increase business performance by investing more in specific assets. However, relational exchange such as the strength of ties and relational norms in between exchange dealers affect the growth of business performance by positively mediating the effect of

a specific investment. Also, integration decisions between exchange parties crucially affect a high level of asset specificity and thereby sustain the firm's performance. And also, buyer and supplier relationships affect to make specific investments (Hart & Moore, 1990). As a result of this, it leads to an efficient trading outcome for the business firm. According to these scholars, asset specificity acts as a mediate role positively in between relational contract and business performance. Therefore, this study hypothesis that;

H6: Asset specificity has a mediating effect on the relationship between relational contract and business performance of small enterprises.

METHODOLOGY

This study used quantitative methods to collect and analyze the data. Unit of analysis of this study is SEs which are defined as establishment with 5 - 24 persons engaged (Department of Census and Statistics, 2016). The study selected Colombo district to conduct the survey because it represents the highest number of SEs in Sri Lanka. Out of 13 Divisional Secretory Divisions (DSD) in Colombo district, one DSD was selected randomly. Accordingly, Seethawaka DSD was selected to gather data. 197 SEs were selected using purposive sample because, no systematic data base regarding the total number of SEs were available in responsible institution. Since, the study applied confirmatory factor analysis, 197 sample is sufficient to make a valid conclusion because Loehlin (1992) suggested that at least 100 cases and 200 observations would be better for the confirmatory factor analysis. The study used purposive sampling since the data was collected under difficulties (lockdown, traveling, and social distance) due to COVID-19 pandemic situation. Data were gathered using a structured questionnaire having face to face interview.

The study measured three key variables such as RC, asset specificity, and business performance. RC is defined as informal agreements and unwritten codes of conduct that govern transactions between exchange parties. The study uses two dimensions as the strength of ties and relational qualities. The strength of ties was measured by using three items as a close tie, interaction, and period (Lu et al., 2012). Relational qualities were measured by using six items such as trust and norms (information exchange, flexibility, solidarity, the role of integrity, and reciprocity) (Dyer & Chu, 2003; Rokkan et al., 1992).

Asset specificity has six dimensions among them four items were measured such as site-specificity, physical asset specificity, human asset specificity, and dedicated asset specificity (Gersch, 2011). Business performance is defined as the operational skill to satisfy the goals of the major stakeholders of the company (Smith & Reece, 1999). It was measured by using two dimensions such as financial performance and non-financial performance (Zahra, 1993). Financial performance was measured by using five items such as profit, income, sales growth, returns to investment, and market share (Rizal et al., 2017). And also, the non-financial performance was measured by using five items such as customers, workers, machinery and equipment, buildings, and lands (Miththrananda & Priyanath 2020).

Both descriptive and inferential statistics were used to test the hypothetical relationships. Under descriptive statistics, whole questionnaire items were measured including main key variables. Under inferential statistics, the study used Partial Least Squire Structural Equation Modelling (PLS-SEM) to test the hypotheses. PLS-SEM helps to examine the interrelationship between multiple independent and dependent variables and facilitate the evaluation of relationships between more than one construct simultaneously. The model was tested with related to inner and outer model to identify the reliability and validity of the reflective variables. Reliability and validity of the model are measured by using indicator reliability, internal consistency reliability, and under reliability of construct; convergent validities and discriminant validity under validity of the construct. The structural model has mainly used five steps as; collinearity issues in the structural model, significance and relevance of the structural model relationships, level of R^2, effect sizes f^2 and finally predictive relevance Q^2. And these steps are used to evaluate the efficiency of the structural model. Smart PLS version 2.0 and SPSS software were used to analyze the hypothetical relationships.

FINDINGS

Considering the characteristics of the respondents in the sample, majority (65.3%) represents male. Age is categorized under 05 categories such as below 25 years, 26-35 years,36-45 years, 46-55 years and above 55 years. From these categories minimum age is 23 years while maximum age is 69 years. 40.7% of the respondents represents above 55 years. Considering the educational level, majority (40.0%) has A/L qualification. 6.0% respondents have degree. Considering the civil status, majority (92.7%) are married. The

general profile of SEs was studied. Majority (22.4 %) represents the category of food products. Manufacture of textile and appeal and manufacture of other non- metallic mineral products have shown two-digit percentage of the sample while the other industrial categories have lower contribution to the sample. However, the sample represents almost all the categories of manufacturing industries. Another salient feature of the sample is that most of the industries (81.1 percent) were initiated by the current owners while the rest (18.9 percent) were started by any other persons. With regard to the number of employees engaged in the industry, about 64 percent of industries have workers between 5 and 9. One of the most important characteristics of the sample is that all SEs show satisfactory performance in profits. With regard to the profit margin per Rs. 100 sales values, the majority of SEs (89.9 percent) earn profit between 6 percent and 10 percent. With reference to the age of firms, it is also interested in highlighting that the majority of the SEs in the sample (83.6 percent) have been established after 1990. Nearly 40 percent of the firms have been established between 2000 and 2009.

The relational contract represents two categories as strength of ties and relational qualities. Most of the respondents (87.8%) states that they meet each other and talk about their strong ties in different networks (social, business, and supportive). However, 35.8% of respondents agreed that they discuss their secret, important and personal matters with their close members of the network. The descriptive data demonstrate that most of the respondents (68.55) have stated somewhat agree or agree with the statements related to creditable and benevolence trust. The respondents have made positive agreements on all the six statements related to the creditable trust and the three statements related to the benevolence trust revealing that the SEs have a higher level of inter-personal trust with the members of their network.

The survey results demonstrate that SEs are rich in transaction-specific assets. The majority (61.7%) agreed that they have made investments to locate firms (or branches, sales outlets, stores, etc.), in a place to serve buyers effectively and to purchase inputs from suppliers cheaply and easily (site-specific assets). Similarly, SEs have a higher level of human-specific assets. Considering the physical assets specificity, only investment to arrange production process to meet the requirements of dealing with exchange partners shows a higher value while the other items have a lower value implying that SEs do not have a higher level of physical specific assets.

The study analyzed data applying two steps procedure under the outer and inner models. The outer model was tested under a reflective variable related to two ways such as reliability and validity of the construct. Although the variables were measured using many items, some constructs compose of a few items which were above the minimum threshold criterion 0.7. Table 1 shows standardized factor loadings which were above the minimum threshold criterion 0.7 confirming the indicator reliability of first-order reflective constructs. Also, table 01 further shows that all the factor loadings were statistically significant at a 0.05 significance level. Hence, the results show strong evidence for indicator reliability of the first order measurement items. Table 1 further exhibits that Cronbach's α was higher than the required value of 0.7 and composite reliability was higher than the recommended 0.7 value. The higher value of Cronbach's α and the composite reliability confirm the convergent validity of the first-order constructs. AVE for each construct was higher than the required value of 0.5 and indicates that each construct can explain more than half of the variance to its measuring items on average.

Table 1: Reliability and Validity of First Order Analysis

	Loading	T statistics	Composite Reliability	Cronbach's α	AVE
Relational Qualities Flexibility			0.968	0.934	0.938
Flexible in environmental uncertainty	0.971	203.36			
Flexible in behavioral uncertainty	0.966	132.63			
Norm of Information Exchange			1.000	1.000	1.000
Useful information	1.000	-			
Norm of Reciprocity			0.909	0.801	0.833
Do not try to gain short term benefits	0.901	34.23			
Ignore the unexpected mistakes	0.925	63.42			
Norm of Role Integrity			1.000	1.000	1.000
Do not engage in cheating	1.000	-			
Norm of Solidarity			0.787	0.641	0.749
Join problem-solving corporately	0.773	13.83			
Work on continue expectation	0.837	25.84			
Trust			0.871	0.705	0.771
Treat fairly	0.897	41.62			
Not knowingly do anything to hurt me	0.859	25.17			

Source: (Survey Data, 2020)

Regarding the discriminant validity, Table 2 demonstrates that none of the inter-construct correlation values was above the square-root of the AVE and satisfied the criterion of the discriminant validity of first-order constructs.

Table 2: Discriminant Validity of First Order Analysis

	1	2	3	4	5	6
Norm of Flexibility	**0.969**					
Norm of Information Exchange	0.645	**1**				
Norm of Reciprocity	0.506	0.381	**0.913**			
Norm of Role Integrity	0.414	0.243	0.544	**1**		
Norm of Solidarity	0.799	0.530	0.388	0.402	**0.865**	
Trust	0.671	0.339	0.386	0.602	0.617	**0.878**

Source: (Survey Data, 2020)

The second-order constructs were developed using latent variable scores of the first-order constructs. All path coefficients (standardized factor loadings) were well above the threshold value of 0.7 (see Table 3). The bootstrapping procedure was conducted to estimate the significance of each path coefficient by examining the t-statistics. All the t-statistics were significant at the 0.05 significance level (see Table 3). Hence, the results show strong evidence for indicator reliability of the second-order constructs. Table 3 further displays that Cronbach's α was higher than the required value of 0.7 and composite reliability was higher than the recommended 0.7 value. With a higher level of Cronbach's α and composite reliability, the second-order constructs were developed reliably. AVE for each construct was higher than the required value of 0.5. The results confirm the convergent validity of the second-order construct.

Table 3: Reliability and Validity of Second Order Analysis

	Loading	T statistics	Composite Reliability	Cronbach's α	AVE
Business Performance					
Finance			0.945	0.912	0.851
Profit has been increased	0.963	134.35			
Income has been increased	0.909	58.68			
Sales growth has been increased	0.894	88.07			
Non-Finance			0.901	0.835	0.752
Machinery & equipment purchased has been increased	0.817	30.22			
Buildings purchased have been increased.	0.859	31.96			
Lands purchased have been increased.	0.922	46.74			
Asset Specificity					
Dedicated Asset Specificity			0.873	0.734	0.775
Invest in a specific design to serve distinct buyers.	0.806	13.23			
Invest in specific designs to serve distinct suppliers.	0.950	39.02			
Human Asset Specificity			0.739	0.593	0.786
Spent money to recruit/train staff to deal with specific exchange partners	0.758	4.93			

Decided to stop dealing with exchange partners, the firm would lose a lot of knowledge	0.773	5.61			
Physical Asset Specificity			**0.942**	**0.907**	**0.844**
Investments in machines, equipment and tooling are dedicated to deal with specific exchange partners.	0.856	27.45			
Internal adjustments to deal effectively with exchange partners.	0.931	64.42			
Spent money and time to cater to exchange partners' specific needs	0.965	246.99			
Site Specificity			**0.990**	**0.979**	**0.979**
Investments to locate a firm in a place to serve specific buyers.	0.992	2.94			
Investments to locate a firm in a suitable place to purchase inputs from special suppliers.	0.987	2.92			

Source: (Survey Data, 2020)

Discriminate validity of the second-order constructs is presented in Table 4 which shows that none of the inter-construct correlation value was above the square-root of the AVE and satisfied the criterion of the discriminant validity of the second-order constructs.

Table 4: Discriminant Validity of Second Order Analysis

	1	2	3	4	5	6
Finance	0.923					
Non - Finance	0.353	0.867				
Dedicated Asset Specificity	0.290	0.248	0.881			
Human Asset Specificity	0.467	0.325	0.440	0.886		
Physical Asset Specificity	0.069	0.273	0.172	0.416	0.919	
Site Specificity	0.305	0.124	0.201	0.058	0.246	0.990

Source: (Survey Data, 2020)

Third-order constructs are presented in Table 5, standardized factor loadings were greater than 0.7 and factors loadings were significant at 0.05 significance level showing the indicator reliability of the third-order constructs revealing that all constructs have a greater extent of indicator reliability. Furthermore, Table 5 indicate that Cronbach's α was higher than the required value of 0.7 and composite reliability was higher than the recommended 0.7 value for all the constructs.

Table 5: Reliability and Validity of Second Order Analysis

	Loading	T statistics	Composite Reliability	Cronbach's α	AVE
Asset Specificity			0.829	0.588	0.708
Human Asset Specificity	0.825	25.83			
Physical Asset Specificity	0.857	19.38			
Business Performance			0.804	0.521	0.673
Finance	0.762	11.66			
Non-Finance	0.875	20.51			

Relational Qualities			**0.885**	**0.851**	**0.606**
Norm of Flexibility	0.804	18.97			
Norm of Reciprocity	0.822	31.03			
Norm of Role Integrity	0.770	17.46			
Norm of Solidarity	0.711	14.46			
Trust	0.780	16.13			
Strength of Ties			**0.916**	**0.890**	**0.688**
Strength B1	0.891	15.27			
Strength B2	0.922	16.45			
Strength S1	0.703	6.93			
Strength S2	0.793	11.36			
Strength S3	0.818	10.44			

Source: (Survey Data, 2020)

The results confirmed the convergent validity of the third-order constructs. Tables 6 demonstrate that AVE for each construct was higher than the required value 0.5 indicating that convergent validity.

Table 6: Discriminant Validity of Second Order Analysis

	1	2	3	4
Asset Specificity	0.841			
Business Performance	0.404	0.820		
Relational Qualities	0.509	0.329	0.778	
Strength of Ties	0.482	0.172	0.467	0.829

Source: (Survey Data, 2020)

Having established the reliable and validated measurement model, the next step is to examine the hypothesized causal relationship among latent variables According to the guideline provided by Hair et al. (2014), the structural model assessment was based on basically 05 steps. The first step is assessing the structural model for collinearity issues. Variance Inflation Factor (VIF) is used to evaluate the multi-collinearity. VIF and Tolerance values use for collinearity checking. If VIF values are lower than 10 and their Tolerance values are higher than 0.2, there is no collinearity problem. VIF values were lower than 10 and tolerance values were higher than 0.2 in this study. Hence can be identified there are no collinearity problems with this model. The second step is assessing the significance and relevance of the structural model and relationships. Path coefficients are assisted to identify the magnitude of the relationship and t-statistics values assist to examine the significance of the relationship of the structural model.

Table 7: Significance and Relevance of Path Coefficients

Hypothesis	Relationship	Path Coefficient (β)	T-statistics	Results
H1	Strength of Ties -> Business Performance	-0.086	0.95	Not supported
H2	Relational Qualities -> Business Performance	0.192	1.93*	**Supported**
H3	Strength of Ties -> Asset Specificity	0.313	5.16**	**Supported**
H4	Relational Qualities -> Asset Specificity	0.363	4.91**	**Supported**
H5	Asset Specificity -> Business Performance	0.348	4.92**	**Supported**

*p<0.05, **p<0.01.
Source: (Survey Data, 2020)

The third step is assessing the coefficient of determination (R^2). This model R^2 represents 39% of the variation in business performance and is explained by relational qualities, the strength of ties, and asset specificity. Hence, the R^2 value of the business performance of the model is 0.39. It can be considered weak. The fourth step is to assess the effect size $(f)^2$. This model represents the 0.096 of effect size in relational qualities, -0.035 of effect size in the strength of ties, and -0.031 of effect size in asset specificity. These values represent the small effect sizes. The fifth step is assessing predictive relevance (Q^2). Q^2 is computed by using Stone-Geisser criterion. It suggests that the model must be able to provide a prediction of the dependent variable is measuring items. If the Q^2 is larger than zero, the model is considered to have predictive relevance. Otherwise, the model lacks to have predictive relevance. Hence Q^2 for business performance is 0.13 and it represents the weak effect. It has predictive relevance because the Q^2 value is larger than zero.

Table 7 shows that the H1 hypothesis represents the negative association between the strength of ties and business performance. And it has not a significant relationship. Rost (2011) stated that strong ties affect improve business performance. Todo et al. (2016) stated that ties of strength affect to improve productivity and innovation skills of the business firm. According to this study, the strength of ties has a negative effect on the business performance of SEs, but the relationship is not statistically significant. H2 hypothesis represents the positive significant association between relational qualities and business performance. Gamage and Priyanath (2019) stated that many scholars empirically were indicated the relational qualities support to improve business performance. Priyanath et al. (2016a) stated that the improvement of relational norms has a significant effect to mitigate the transaction cost and its effect on the growth of business performance. Heide and John (1992) found that

relational norms positively correlated with business performance. This study provides similar results as relational qualities such as trust and norms have a positive impact on the business performance of SEs.

Table 7 demonstrates that the H3 hypothesis represents a significant positive association between the strength of ties and asset specificity. Gerdoci et al. (2016) stated that the strength of relational ties affects to reduce the transaction cost and affect to improve the asset specificity. Lui et al. (2009) stated that empirical relationship by explaining the relational exchange suggest that more cooperative behavior that represents trust between parties affect to increase the asset specificity. This study also provides similar empirical evidence revealing that the strength of ties has a positive impact on the asset specificity of SEs. Table 7 shows that the H4 hypothesis represents a significant positive association between relational qualities and asset specificity. As well, Mithas et al. (2008) stated that non-contractibility such as information exchange, flexibility, and trust affect asset specificity. According to this research study, relational qualities such as trust and norms have a positive impact on the asset specificity of SEs. Table 7 further shows that the H5 hypothesis represents a significant positive association between asset specificity and business performance. Mang (1998) stated that the transaction cost of the firm is decreased by investment on specific transaction assets and it supports to improve the business performance. According to this study, asset specificity has a positive impact on the business performance of SEs.

Finally, the model has tested the mediated effect of asset specificity on the relationship between relational contract and business performance. Therefore, this model has two mediate effects such as the mediate effect of asset specificity on the relationship between relational qualities and business performance and the mediate effect of asset specificity on the relationship between the strength of ties and business performance.

Table 8: Mediating Effect of Asset Specificity through Relational Qualities & Business Performance

Path	Direct effect model		Indirect effect[c]	S_e[d] (SD)	t-stat[e]	Total effect[f]	VAF	Type of mediation
	β[a]	t-stat	axb		(axb)/ S_e	(axb) + c		
Relational Qualities -> Business Performance	0.192	1.926	0.126	0.033	3.818	0.318	0.396	Complementary mediation
Relational Qualities -> Asset Specificity	0.363	4.905						
Asset Specificity -> Business Performance	0.348	4.925						

Source: (Survey Data, 2020)

Table 9: Mediating Effect of Asset Specificity through Strength of Ties & Business Performance

Path	Direct effect model		Indirect effect[c]	S_e[d] (SD)	t -stat[e]	Total effect	VAF	Type of the mediation
	β[a]	t-stat	axb		(axb)/ S_e	(axb) + c		
Strength of Ties -> Business Performance	-0.086	0.950	0.109	0.036	3.028	0.023	4.74	Indirect - only mediation
Strength of Ties -> Asset Specificity	0.313	5.165						
Asset Specificity -> Business Performance	0.348	4.925						

Source: (Survey Data, 2020)

Table 8 and 9 results provide the mediate effect of asset specificity on the relationship between relational qualities and business performance & strength of ties and business performance. The relationship between relational qualities and business performance & strength of ties and business performance can be considered as direct relationships in the mediate analysis. The mediating effect of asset specificity on the relationship between relational qualities and business performance exhibitions 39.6% of the total effect. It implies that asset specificity plays a mediating role to increase business performance of SEs. The mediating effect of these asset specificity on the relationship between strength of ties and business performance exhibitions 4.74% of the total effect.   T9

shows that the indirect-only mediation based on the mediating effect decision hierarchy proposed by Zhao et al. (2010).

CONCLUSION

Results revealed that the strength of RC leads to asset specificity and business performance of SEs. Relational qualities indicate a positive impact on business performance. In addition, the strength of ties has a positive association with asset specificity while relational qualities have a positive relationship with asset specificity. Furthermore, asset specificity has a positive impact on business performance. Mediate role of asset specificity has indicated that indirect-only mediation effect the relationship between the strength of ties and business performance while that of has a complementary mediation in the relationship between relational qualities and business performance. Results indicate that, the strength of ties and relational qualities affect to encourage asset specificity and thereby asset specificity effects increase the business performance. Hence, this study generates sufficient empirical evidence to confirm that a relational contract has an influence on asset specificity and the business performance of SEs in Sri Lanka.

The study recommends important solutions to sustain the policies to encourage the SEs. Since the network relationship is not considerably affected to improve business performance, it is very important to build a better mechanism to create a strong relationship between exchange parties. Therefore, the government can develop different activities to generate network relationships among them by filling the lack of specific investment for small industries. However, policymakers can organize the project and procedures for improving the network formation programs by conducting seminars, conference, providing sufficient knowledge for modern communication techniques for easily conduct the business transactions, and providing details regarding reliable and guaranteed exchange dealers through introducing a web page with related to the responsible government agency in order to improve the entrepreneurs' ability to establish the more connections build with various exchange dealers from quick and easy ways and expand the network relationship capacity with recognizing new exchange dealers.

Scholars have not examined the mixing of these theories and concepts and empirically tested the practical efficacy of the theories especially in SEs of Sri Lankan context. This study attempts to fill this gap by exploring how RC

affects asset specificity and business performance particularly in SEs in Sri Lanka. And also this study offers new empirical findings to the knowledge for existing empirical literature base on relational contract, asset specificity, and business performance. Previous scholars were not provided practical knowledge by exploring the effect of relational contracts on asset specificity and business performance, particularly in SEs. But this study offers practical knowledge regarding this empirical investigation. According to this empirical investigation, the study fills the empirical gap by disclosing empirical evidence providing a substantial contribution to empirical knowledge related to SEs.

This study is only limited to SEs of Seethawaka DS Division. Therefore, this study cannot be generalized base on the entire economy of Sri Lanka. If this study is studied base on other areas, can be improved the knowledge by identifying this perspective. Hence, future researchers can be used wider extent areas for their investigations Another limitation refers to the fact that the sample of this study is a very small subset of the total population. Hence future researchers can be adopted a large sample to present the entire population. Another foremost limitation is respondents who participated in this survey-based only on a single business sector. And also, primary data were collected as personal data. Hence, it is based on the personalized of small entrepreneurs. Therefore, cannot be truly identified those data have accurate data from whole entrepreneurs. Furthermore, future researchers should need to focus on additional moderate constructs base on technological aspects to investigate the effect of asset specificity and business performance by changing relational exchange behavior. And also well-established systematic methodology is needed to be addressed the imminent investigations to measure these theories and concepts like relational contact theory, network strength, asset specificity under transaction cost theory, and business performance in a wider viewpoint.

REFERENCES

Anderson, E., & Weitz, B. (1992). The use of pledges to build and sustain commitment in distribution channels. *Journal of Marketing Research, 29(1),* 18-34.

Baker, G., Gibbons, R. & Murphy, K.J. (2002). Relational contracts and the theory of the firm. *Quarterly Journal of Economics, 117*(1), 39-84.

Bolino, M. C., Turnley, W. H., & Bloodgood, J. M. (2002). Citizenship behavior and the creation of social capital in organizations. *Academy of Management Review, 27*(4), 505-522.

Buvik, A., & Reve, T., (2001). Asymmetrical deployment of specific assets and contractual safeguarding in industrial purchasing relationships. *Journal of Business Research*, *51*, 101-113.

Buvik, A., & Andersen, O. (2002) The impact of vertical coordination on ex-post transaction cost in domestic and international buyer-seller relationships. *Journal of International Marketing, 10*, 1 – 24.

Chandler, G. N. McKelvie, A., & Davidsson, P. (2009). Asset specificity and behavioral uncertainty as moderators of the sales growth- employment growth relationship in emerging ventures. *Journal of Business Venturing, 24(4),* 373-387.

Carey, S., & Lawson, B. (2011). Governance and social capital formation in buyer-supplier relationships. *Journal of Manufacturing Technology Management*, *22*(2), 152-170.

Carmel, E., & Nicholson, B. (2005). Small firms and offshore software outsourcing: high transaction costs and their mitigation. *Journal of Global Information Management, 13*(3), 33-54.

Dyer, J. H., & Chu. W. J. (2003). The role of trustworthiness in reducing transaction costs and improving performance: empirical evidence from the United States, Japan, and Korea. *Organization Science, 14(1),* 57-68.

Flynn, B. B., Huo, B., & Zhao, X., (2010). The impact of supply chain integration on performance: a contingency and configuration approach. *Journal of Operational Management. 28*, 58-71.

Gamage, K., & Priyanath, S., (2019). Relational norms, opportunism & business performance: An empirical evidence of gem dealers in Sri Lanka. *Sri Lanka Journal of Economic Research,* 6(2), 39-67.

Gerdoci, B., Skreli, E., Panariti, S., & Repaj, E., (2016). Relational ties and transaction costs – The moderating role of uncertainty: *International Food and Agribusiness Management Review,19 (2),*189-206.

Gersch, M. (2011) Specificity-based commitments from co-evolutionary perspective-first conceptual considerations and implications for relationship management, retrieved from www.papers.ssrn.com.

Geyskens, I., Steenkamp. J., & Kumar, N., (2006). Make, buy, orally: A transaction cost theory meta-analysis. *The Academy of Management Journal, 49 (3):* 519-543.

Gulati, R., & Sing, H. (1998). The architecture of cooperation: Managing coordination costs and appropriation concerns in strategic alliances, *Administrative Science Quarterly*, *43*(4), 781-814.

Hair, J., Hult, T., Ringle, C., & Sarstedt, M. (2014). A primer on partial least squares structural equation modeling. Sage.

Hart, O., & Moore. J. (1990). Property rights and the nature of the firm. *Journal of Political Economy 98(6),* 1119-1158.

Heide, J., & John, G. (1990). Alliances in industrial purchasing: The determinants of joint action in buyer-seller relationships. *Journal of Marketing Research*, 24-26.

Heide, J., & John, G. (1992). Do norms matter in marketing relationships? *Journal of Marketing, 56,* 32-44.

Hobbs, J. E. (1996). A transaction cost approach to supply chain management. *Supply Chain Management, 1*(2), 15-27.

Indris, S., & Promina, I. (2015). Internal and external environment analysis on the performance of small and medium industries (SMEs). *International Journal of Scientific & Technology Research, 4(4),* 188 -196.

Ivens, B. S. (2004). How relevant are different forms of relational behavior? An empirical test based on Macneil's exchange framework. *Journal of Business & Industrial Marketing, 19(5),* 300-309.

Jagwem, J. N. (2011). *The impact of transaction costs on the participation of smallholder farmers and intermediaries in the banana markets of Burundi, Democratic Republic of Congo and Rwanda*, PhD Thesis, Department of Agricultural Economics, Extension and Rural Development, University of Pretoria, South Africa.

Lu, H. Feng, S. Trienekens, J. H., & Omta, S.W.F (2012). Network strength, transaction-specific investments, interpersonal trust and relationship satisfaction in Chinese agri-food SMEs. *China Agricultural Economic Review*, *4*(3), 363-378.

Lui, S., Wong, Y.-y., & Liu, W. (2009). Asset specificity roles in inter-firm cooperation: Reducing opportunistic behavior or increasing cooperative behavior? *Journal of Business Research, 62(11),* 1214-1219.

Macneil I.R., (1983), Values in contract: Internal and external, *Northwestern University Law Review, 78,*340-418.

Macneil, I. R. (1985). Relational Contract: What we do and do not know. *Wisconsin Law Review,* 483-525.

Mang. P. Y., (1998), Exploiting innovation options: an empirical analysis of R & D – intensive firms. *Journal of Economic Behavior and Organizations 35,* 229-242.

Mithas, S., Jones, J. L., & Mitchell, W., (2008). Buyer intention to use internet-enabled reverse auctions: The role of asset specificity, product specialization, and on-contractibility. *MIS quarterly,*705-724.

Miththrananda, B.Y.G.W., & Priyanath, H.M.S. (2020). The Impact of Asymmetric Information on Opportunism and Business Performance: An Empirical Investigation of Small Enterprises in Sri Lanka, *Asian Journal of Multidisciplinary Studies*, *8*(4), 44-57.

Moers, F. (2000). Financial and non-financial performance measures and managerial short term orientation: The interactive effect of performance targets. *MARC Working Paper*, Maastricht University, MARC / Department of Accounting & Auditing, Netherlands.

Nooteboom, B. (1993). Firm size effect on transaction cost, *Small Business Economics*, *5*, 283-295.

Petković, S., Jäger, C., & Sašić, B. (2016). Challenges of small and medium-sized companies at the early stage of development: Insights from Bosnia and Herzegovina. *Management: Journal of Contemporary Management Issues, 21*(2), 45-76.

Poppo, L., & Zenger, T. (2002). Do formal contracts and relational governance function as substitutes or complements? *Strategic Management Journal*, *23*(2), 707-725.

Prasad, S., Tata, J., & Guo, K. (2012). Sustaining small businesses in the United States in times of recession: Role of supply networks and social capital. *Journal of Advances in Management Research, 9(1),* 8 - 28.

Priyanath, H. H. S., & Premaratne, S. P. (2014). Government SME development programs in Sri Lanka: A Review in the lens of transaction cost economics, *Sabragamuwa University Journal*, *14*(1), 59-81.

Priyanath, H. H. S., Jayasinghe, D. J. S., & Premaratne, S. P. (2016a). Effect of relational norms on mitigating opportunism: A case of smallholder vegetable farmers in Sri Lanka, *Journal of Business and Management, 18*(7), 1-9.

Priyanath, S., Jayasinghe, D. J. S., & Premaratna, S.P. (2016b). Effects of relational norms on mitigating transaction costs: A case of smallholder vegetable farmers in Sri Lanka. *International Journal of Business and Management Invention, 1(19),* 8-18.

Richard, P., Yip, G., Devinney, T., & Johnson, G., (2009). Measuring organizational performance: Towards methodological best practice. *Journal of Management*, 35 (3), 718-804.

Rokkan, A., Heide, J., & Wathne, K. (2003). Specific investments in marketing relationships: Expropriation and bonding effects. *Journal of Marketing Research, 40(2),* 210-224.

Rost, K., (2011). The strength of strong ties in the creation of innovation. *Res. Policy 40*, 588 – 604.

Samouel, P. (2007). Does time impact relational norms in bilateral exchange? The small business case. *Journal of Small Business and Enterprise Development, 14(1),* 136-143.

Siguaw, J., Simpson, P., & Baker, T. (1998). Effect of supplier market orientation n distributor market orientation and the channel relationship: The distributor perspective. *Journal of Marketing, 62,* 99-111.

Silkoset, R. (2013). Negative and positive effects of social capital on co-located firms' withholding efforts. *European Journal of Marketing. 47*(2), 174-197.

Smith, T.M & Reece, J.S. (1999). The relationship of strategy, fit, productivity and business performance in a services setting. *Journal of Operations Management, 17(2),* 145-161.

Todo, Y., Matous, P., & Inoue, H., (2016). The strength of long ties and the weakness of strong ties: Knowledge diffusion through supply chain networks. *Research Policy, 45*, 1890-1906.

Tsai, W. (2001). Knowledge Transfer in Intraorganizational Networks: Effects of Network Position and Absorptive Capacity on Business Unit Innovation and Performance. *Academy of Management Journal*, *44*(5), 996-1004.

Tsai, W., & Ghoshal, S. (1998). Social capital and value creation: the role of inter-firm networks. *The Academy of Management Journal*, *41*(4), 464-476.

Uesugi, I., (2015). *Interfirm networks in manufacturing industry agglomerations in Japan: Evidence from survey data*. In: Watanabe, T., Uesugi, I., Ono, A. (Eds.), The Economics of Interfirm Networks. Springer, Japan: Tokyo.

Venkatraman, N., & Ramanujam, V. (1986). Measurement of business performance in strategy research: A comparison of approaches. *Academy of Management Review, 11*(4),801-814.

Williamson, O. E. (1979). Transaction-Cost Economics: The governance of contractual relations. *Journal of Law and Economics,* 2, 233-261.

Williamson, O. E. (1981). The economics of organization: The transaction cost approach. *American Journal of Sociology, 3*, 548-577.

Williamson, O. E. (1985). *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*. New York, NY: The Free Press.

Yeboah, M. A. (2015). Determinants of SME growth: an empirical perspective of SMEs in the Cape Coast metropolis in Ghana. *Determinants of SME Growth*, *14*(2), 1-31.

Zahra, S. (1993). Environment, corporate entrepreneurship, and financial performance: A taxonomic approach. *Journal of Business Venturing, 8*, 319-340.

Zhang, A. (2009). Corruption as a determinant of the transaction governance structure. *Strategic Outsourcing: An International Journal*, *2*(1), 27-36.

Zhao, X., Lynch, J. G., & Chen, Q. (2010). Reconsidering Baron and Kenny: myths and truths about mediation analysis. *Journal of Consumer Research, 37*(2), 197-206.

Zhao, Y. & Wang, G. (2011). The impact of relation specific investment on channel relationship performance: Evidence from China. *Journal of Strategic Marketing. 19(1),* 57-71.