

# Institutional Approach to the Regulation of Small Business as an Economic System

## Enfoque institucional de la regulación de la pequeña empresa como sistema económico

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#### ABSTRACT:

Traditional approaches addressing the management issues in terms of the subject, object, principles, functions, goals and management methods are quite often used today in the study of small business development. This approach has certain limitations based on a subjective approach. The article is devoted to the issues of small business management using the institutional approach and the impact on small business as an economic system. The institutional structure of small business, including institutional subjects, institutional objects, institutional environment and institutional mechanism has been investigated. The role of formal and informal institutions has been revealed along with their positive and negative impacts on the small business development. A study of the institutional regulation of small business as the economic system allows to ensure sustainable development of small business subjects by means of the effective use of limited economic resources and minimization of internal and external risks.

**Key words:** small business, institutional regulation, formal and informal institutions

#### RESUMEN:

Los enfoques tradicionales que abordan las cuestiones de gestión en términos de sujeto, objeto, principios, funciones, objetivos y métodos de gestión son muy a menudo utilizados hoy en día en el estudio del desarrollo de pequeñas empresas. Este enfoque tiene ciertas limitaciones basadas en un enfoque subjetivo. El artículo está dedicado a las cuestiones de la gestión de pequeñas empresas utilizando el enfoque institucional y el impacto en las pequeñas empresas como un sistema económico. Se ha investigado la estructura institucional de la pequeña empresa, incluyendo sujetos institucionales, objetos institucionales, entorno institucional y mecanismo institucional. Se ha revelado el papel de las instituciones formales e informales junto con sus impactos positivos y negativos en el desarrollo de la pequeña empresa. Un estudio de la regulación institucional de las pequeñas empresas como sistema económico permite asegurar el desarrollo sostenible de las pequeñas empresas mediante el uso efectivo de recursos económicos limitados y la minimización de los riesgos internos y externos.

**Palabras clave:** pequeña empresa, regulación

# 1. Introduction

The use of the institutional approach is particularly relevant at present because it reduces the uncertainty and promotes the formation of new approaches to the management of institutions that could be more preferable compared to the traditional management methods and facilitates to stronger performance in meeting targets. The use of the institutional approach is linked to the analysis of specific situations and formation of more realistic models that is more practical and close to reality.

Particular importance should be given to the issues of interaction between small business and the country's institutional system. Classical management focuses on subject, object, principles, functions, objectives and management methods that have certain restrictions connected with the possible orientation on the subjective side of the relationship. Problems also arise with the complexity of the allocation of subjects and objects of management at the methodological level, for example, at the level of socio-economic macro-systems. Institutional approach offsets the values used in the traditional management and focuses on institutions.

A study of small business as a separate system allows to optimize institutional regulation in it and promotes a closer interaction between small businesses and other elements of the system. The small business includes various elements (individual entrepreneurs, limited liability companies, joint stock companies, farms, economic partnership) and various degree of interaction between these elements and the elements of the external environment. The integration of small and large businesses, the participation of small business in the system of public-private partnerships, raising capital through corporatization, participation by small businesses in the self-regulatory organizations, trade unions create sustainable relationships between the elements and ensure the sustainability of small business as an economic system as a whole.

Institutional approach eliminates values that are used in the traditional management, and focuses on institutions. A study on the institutional regulation of small business as the economic system will ensure the sustainable development of small business in terms of increased economic and social risks and uncertainty when making managerial decisions.

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## 2. Literature review

Scientific works devoted to the study of small business reveal a variety of issues. The issues of small business management are rather urgent at present and some scholars consider small business as a potential leader for transition to new level of the economic development (Drucker 1992). Small business becomes a tool of the new economy and invests a significant proportion of the capital costs for computers and communication equipment. At the same time small business is a fairly heterogeneous environment with occupational and sectoral differences (Buckley & Mentis, 2002). Different countries use different approaches (quantitative and qualitative), allowing to classify enterprises into the small sized category. Some economists dedicated their research to this complex issue (Brooksbank, 1991). Small business requires the state support for its development due to the specific features of attracting resources and business organization (Marlow 1992).

*General traditional systems theory provides a definition of a system as a combination of interconnected elements that are connected to each other in a way when if one element is changed, the other elements will change too, and therefore the whole combination will change* (Bertalanffy, 1950). The main difference between "Neosystems" and the classical approaches to the study of systems is the transition from the domestic research system (endogenous approach) to the external study (exogenous approach). System in the new understanding is an integral part of the world relatively stable in space and in time, pointed out by an observer

according to the spatial or functional characteristics (Kleiner 2010).

Foreign and domestic researchers were involved in the study of theoretical and practical issues of formation and development of the institutional economics. The issues of the evolution of institutions and their impact on economic growth from the historical point of view were explored (North 1993). The regulating role of institutions, the system of conflicts and contradictions in them were studied (Galbraith 2004).

However, at present scholars pay little attention to the challenges of small business as an economic system in terms of the effect of the institutional approach, that does not allow to create conditions for its sustainable development.

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### 3. Materials and methods

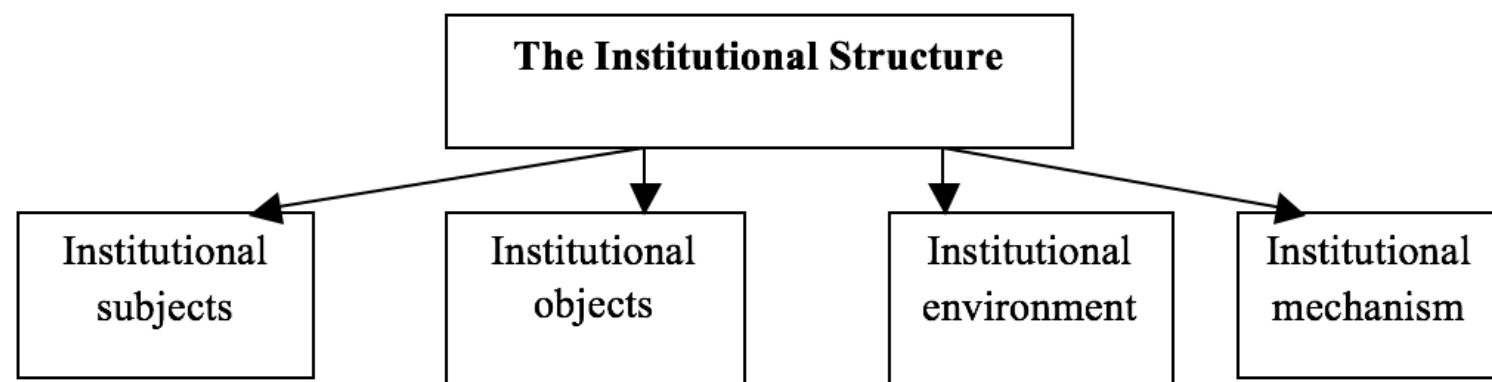
This article is based on the theoretical and methodological research of the leading scholars in the field of economic theory, general management theory, institutional approach to the regulation of economic activity of the business, allowing to consider the impact of formal and informal institutions on small business as the economic system. During the research the author used general scientific methods of theoretical and empirical methods, applied the abstract-logical methods, systematic approach, which allowed the author to reveal positive and negative sides of the impact of formal and informal institutions on the development of small businesses

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### 4. Results and discussion

In our opinion the concept of the institutional structure is fundamental in the study of the regulation of small business as a system. Some are led to think the institutional structure as a totality of the various institutions, both formal and informal, which define the economic behavior of business entities (Vanberg 1994).

The institutional structure includes such elements as institutional subjects, institutional objects, institutional environment and institutional mechanism (Figure 1).



**Figure 1.** The Institutional Structure

Institutional subjects could include an ordered set of institutions that have had an impact on the objects of regulation. Depending on the objectives of the study they could include a state, social institutions, the ownership institution, market, etc. Subjects depending on their nature could perform the role of both formal and informal institutions (Vanberg 1994). The role of informal institutions involves the ethical or moral principles which may vary over time. Formal institutions are official institutions with the authority to regulate entities on a legal basis. The relationship between formal and informal institutions largely makes up the national economic business model.

Institutional objects include the elements targeted by the effects of entities. Objects have been defined depending on the type and purpose of the study. In turn, the objects could be the institute of business, institute of entrepreneurship, etc.

The institutional environment is a part of the institutional structure and includes a set of political, economic, moral, legal and other rules and regulations of behavior, that facilitate

interaction between people.

Institutional mechanism has to coordinate and motivate the activities of the economic entities during their work. The mechanism could include various methods and tools both direct impact (administration) and indirect impacts (market). The ratio between these instruments depends on many factors, in particular, can be determined by the level of economic growth.

Considering the fact that small business is an economic system its institutional regulation as a system is aimed at the formation of the standards of behavior executed by institutional actors along with formation of the values to streamline and formalize relationships between different institutions, maintaining the required level of consistency within one institution and between the institutions of the whole system, as well as functions to eliminate deviations from the tasks of small business as a system.

The objective of the institutional regulation of small business as a system is the sustainable development of small businesses through the effective use of limited economic resources and creation of economic, financial, and organizational conditions that motivate entrepreneurs in expanding and improving productive activities for sustainable development and minimize internal and external risks.

The primary task of the institutional regulation is to create conditions for an effective impact on the behavior of economic agents (the subjects of small businesses) that includes a set of economic, social, political, regulatory rules, formed the basis for social production, exchange and consumption.

Institutional regulation of small business as a system is carried out through formal and informal institutions. Formal institutions are based on the official legal provisions that regulate the behavior of economic agents. Informal institutions include conventional standards of behavior. Informal institutions include the culture, mentality, traditions, religion, state of mind, which determine the processes of development of economic systems as a whole and small business as a system, in particular. The informal institutional actors (legal entities, informal organizations and groups) are the components of informal institutions. In the process of social interaction the informal actors could create their own standards of behavior, which extend both to the formal and informal institutions.

The institution of taxation has a large potential impact on the development of small business because through taxes the government could conduct protective or restrictive measures against specific business lines or regions. The primary task of the tax regulation is the consolidation of finances by the government in the budgets of different levels to solve the problems of social, economic, innovative development of the country. The institution of taxation is based on the permanent functions of taxes (fiscal, regulatory, stimulating and other functions) and has both stability and mobility. Stability of the institution should make entrepreneurs more confident in planning economic activities, but mobility must ensure a link with the economic situation in the country.

Nowadays, the shortcomings in the tax system have led to bureaucratization and excessive state administration. There is a special tax treatment for small business in order to prevent withdrawal of enterprises in the shadow economy such as a simplified taxation, in the form of single tax on imputed income, single agricultural tax, patent and other forms. This has allowed to optimize legally the amount of taxes paid by entrepreneurs. Each of these systems has its positive and negative sides, that require an individual approach to each company in the transition to special tax regimes.

The institution of taxation should be focused on simplifying the tax system and administration in general, that will allow the entrepreneur to think about the optimization of production, not the tax paying procedure.

The imperfection of this institution facilitates the development of the informal shadow economy institution. This institution operates both on the basis of legal structures, engaged in misuse of funds, encashment, conclusion of fictitious contracts and on the basis of illegal structures

engaged in racketeering, kickbacks, etc.

The institution of private ownership affects the willingness to invest, determines the structure of the investments. The basis for the institution of private ownership is a legitimacy of law standards, including the legality of the owner's powers in respect to certain assets. Violation of the legitimacy of ownership rights is caused by the corruption, imperfection of the judicial system, distrust to large asset owners in terms of their legality of ownership, legal illiteracy, etc. These negative factors lead to the formation of the environment, when the agents do not have full confidence in the legitimacy of their right of possession and they will not cause sanctions by the state that increases the risk of contracts and transactions.

In practice, the imperfection of the institution of private property leads to the fact that entrepreneurs resort to the informal interaction with the authorities, judicial system, governmental structures, which in turn, gives rise to the formation of informal institutions and leads to the uncompetitiveness of state institutions.

The uncompetitiveness of state institutions is caused by the fact that their services do not meet the requirements of customers in terms of reliability and efficiency which required the need to search other ways by clients, not always legal, in particular, the emergence of informal institution of raids and greenmail. Raid is the process of taking over an enterprise in opposition to the desires of the owners of by the illegal acquisition of the company controlling stake. Greenmail is the actions of raiders by means psychological blackmail or, so called, highly intellectual extortion. Greenmail is usually lawful, but its actions also bring a considerable loss to the company's owner.

The institution of contractual relations is based on the possibility for the parties to agree the legal behaviors proposed by the legislation or on the creation of such legal models that could be in the form of contracts. The institution of contractual relations has been developed on the basis of market relations progression.

We must use the new contractual behavior patterns in the form of concessions, agent agreements, commission agreements and others that will promote business growth. Development of contractual relations regarding the dispute resolution reduces the time and costs on resolving disputes, increases the stability and resilience of the relationship. The imperfection of the institution of contractual relations leads to corruption, which prompts to make transactions on the basis of illegal behaviors.

Institution of the public procurement includes the issues of procurement of goods, works and services for state needs at the expense of budget funds and should be based on such principles as fairness and equality of the bidders which means that all participants have equal rights to bid, equal access to the information on bidding; transparency which means openness to the information on public procurement; the effectiveness of the use of public funds entails the optimization of the budgetary funds when bidding. The imperfection of this institution leads to the establishment of the institution of personalized relationship, so called cronies in the government.

The institution of public support for small business plays an important role in the development of entrepreneurship and has a number of specific features. Small business are varied in industry composition, therefore, we can identify the specific areas of business support. The different life cycle stages of an enterprise also dictate the various forms of support in the light of the federal, regional and municipal policies. It is necessary to conduct evaluation of small business support to identify issues and make better management decisions. The imperfection of this institution leads to the establishment of an informal institution of corruption that is connected with bribes and kickbacks. There are a lot of reasons for the emergence of this institution, the one of them is the weak system of transactions openness performed by the state authorities as well as the lack of control over these actions by the competent authorities and the imperfection of the punishment system.

The institution of lending and borrowing is traditionally considered as the most important

financial source for the development of economic activities of enterprises by attracting borrowed sources for the development of the company. This institution is a major component of the financial sector. The functioning of this institution is based on the principles of repayment, interest payment and urgency. Though this institution is seemed to be sophisticated due to the large number of credit structures and varied forms of debt, we can note that this institution doesn't always fulfill its primary function –the development of the investment sphere of enterprises, but is limited to separate consumer activities. The imperfection of this institution could be associated with high interest rate, that prevents the use of this financing source in full. All this contributes to the development of the institution of civil loan which is focused mostly on transactions between individuals, based both on verbal agreements and promissory notes and often recognized by flexible deadlines, lower interests rate or even their absence and other features.

The institution of wage labour is characterized by contractual relationship based on the labour legislation. There are two most common versions of the purchase and sale of labour: individual labour contracts and collective contracts. The cost of labour power is paid in the form of wages, which is influenced by various factors such as lowering the price of labour (rise in labour productivity) and contributing to its increase (increase of the qualification of employees). In terms of the development of scientific and technological progress the labour market attaches major importance to the industrial, professional and qualifying mobility of the labour force which also includes the freedom of movement. The imperfection of labor, tax legislations, as well as a number of cultural, social, economic and other factors cause the formation of the institution of informal employment. This institution includes self-employed persons and entrepreneurs, officially unregistered; family workers, as their activities are not regulated by law; employees working in the informal sector; informal employees working in the formal sector of the economy. The informal nature of work is based on a high degree of uncertainty of the work, job insecurity, lack of performance by employees of their obligations. At the same time, it doesn't reduce the attractiveness of informal employment to potential employees, because it is characterized by sufficient availability of job and does not provide the registration and restrictive formalities. Ineffective sanctions to the employers who violate labor laws lead to the progression of informal employment. This sector is currently being generated by taxes and obligatory payments saving to off-budget funds. The condition for the legalization of self-employment should be the simplification of the tax and accounting reporting. Establishing appropriate conditions for financial stabilization of informal employment is essential for its reduction in small business that can be achieved by means of the creation of guarantee funds to support small business.

Institution of market pricing involves the pricing of goods and services on the basis of interaction of supply and demand. Pricing is valid on the basis of such principles as price targeting, which implies the establishment of economic and social challenges facing the producer of the goods; the principle of continuous pricing process that determines the need to determine prices at different stages of production; the principle of the unity of pricing and control over observance of prices means the need to control of pricing order by producers, especially by monopolists, as well as in terms of primary commodities and socially valuable goods. In case when the practice of transfer pricing is not fully developed it is used to avoid taxation by individual companies and it is not always legal, so we can conclude that this institution is not fully formal yet. We should review the tax and customs legislation as well as the issues of state administration and control over transfer pricing.

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## **5. Conclusion**

Thus, the institutional approach to the regulation of small business as an economic system is aimed at the sustainable development of small business subjects by means of the effective use of limited economic resources, as well as the establishment of economic, financial and administrative prerequisites that motivate entrepreneurs to expand and improve production

activities for sustainable development and minimizing internal and external risks. The role of formal and informal institutions of small business regulation as a system has been revealed in terms of formation of the standards of behavior executed by institutional actors along with formation of the values to streamline and formalize relationships between different institutions, maintaining the required level of consistency within one institution and between the institutions of the whole system, as well as functions to eliminate deviations from the tasks of small business as a system. The role of the institutional environment and institutional mechanism aimed at coordinating and motivating the activities of the economic entities is very important.

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