Small Business Institute® Journal
2019, Vol. 15, No. 1, pp. 49-68

Small Business Institute®
ISSN 1944-1150/69

MICRO-FOUNDATIONS OF RESOURCES, CAPABILITIES, AND FIRM PERFORMANCE: A LOOK AT LMX

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Abstract

The purpose of this paper is to develop a conceptual model on leader-member exchange (LMX), a micro-foundation that predicts macro level outcomes, specifically firm performance. Based upon a comprehensive review of social exchange and LMX, the authors develop a conceptual model related to small business firm performance. The paper outlines that, greater average LMX facilitates resource exchange and dynamic capabilities. Increased resource exchange and dynamic capabilities subsequently have a positive mediating effect on firm performance. The model also posits that smaller span of control, more interactive job design, and more productive exchanges will positively moderate the relationship between average LMX and resource exchanges and dynamic capabilities. The paper extends the literature on micro-foundations in the strategic management literature to link LMX and small business performance. There is a need for small business owners to encourage strong relationships with their subordinates. Although this implication is obvious, the actual process is not. The model enhances the understanding of how the role of LMX promotes the firm performance for small businesses, not only directly, but also through resource exchange and dynamic capabilities.

Keywords: Leader-member exchange; small business; resources, capabilities, firm performance

Introduction

Small businesses are a vital source for job production and commercial growth within a given economy (Thurik, & Wennekers, 2004). Yet, there is also a high failure rate for small businesses due to the liability of being new and small (Laitinen, 1992). Small businesses are not inherently just smaller versions of larger companies, they face a unique set of size and resource-related challenges (Baird, Lyles & Orris, 1994). For example, the survival and growth of small businesses generally depends on the effective use of their limited resources in the supply chain (McDowell, Harris, & Gibson, 2010).

Full Citation:
Muldoon, J., Bendickson, J.S. and Mayherne C.F. (2019). Micro-Foundations of Resources, Capabilities, and Firm Performance: A look at LMX. Small Business Institute® Journal. Vol. 19, No. 1, pp 49-68

Scholars have long been researching specific success metrics (e.g., d'Amboise, & Muldowney, 1988; Huck & McEwen, 1991) and have found that several factors have led to small business success, including capital, planning, uniqueness of the venture, knowledge of the industry, and managerial/leadership style and expertise. It is not surprising that management/leadership should play such a crucial role in the financial success of small businesses given the storied impact it has had on the successes of larger organizations (e.g., Gupta, & Govindarajan, 1984; Miller, Xu, & Mehrotra, 2015). A general explanation for this occurrence is that the fact that many workers say the most stressful part of the job is their relationship with their supervisor. Indeed, one of the key variables that separates performance from failure is the type of leadership style that the manager demonstrates. We seek to further explore the relationship between supervisor and subordinates, specifically the quality of that relationship, to offer a deeper perspective on how leadership contributes to performance in small firms.

The principal job of the manager is to gain resources and cooperation from members of the corporation (Barnard, 1938). The ability of management to gain these resources through legal contracts and monitoring is limited due to issues of cost and the incompleteness of contracts (Williamson, 1981). Therefore, managers are encouraged to enter into social relationships that can secure vital resources from the subordinates for the benefit of the firm (Cappelli, Bassi, Katz, Knoke, & Osterman, 1997; Rousseau, 1998). Supervisors perform certain managerial functions that make them essential to organizational success. Consequently, supervisors must create quality relationships with their subordinates as a means of ensuring the organization will function properly (Organ, 1988).

The most prominent theory examining the quality of the supervisor/subordinate relationship is Leader-Member Exchange (LMX) (Bernerth, Armenakis, Field, Giles, & Walker (2007); Graen & Uhl-Bien, 1995). Previous research has uncovered several benefits of social exchange, including higher levels of promotion and pay (Gerstner & Day, 1997), job satisfaction (Graen, Novak, & Sommerkamp, 1982), organizational commitment (Oliver, 1990; Eisenberger et al., 2010), psychological empowerment (Liden, Wayne, & Sparrowe, 2000), decreased burnout (Thomas & Lankau, 2009), and lower levels of turnover intentions (Scandura & Graen, 1984). In relationships that are high in LMX, subordinates and supervisors possess feelings of affection, respect, and trust for each other (Bernerth, et al., 2007; Liden & Maslyn, 1998).

Based on these relationships, subordinates are more willing to perform duties for their supervisor outside of their formal work contract (Organ, Podsakoff, & MacKenzie, 2006; Scandura & Graen, 1984). To compensate subordinates for these additional efforts, supervisors offer more resources and/or more discretion (Graen & Scandura, 1987; Graen & Uhl-Bien, 1995; van Breukelen, Schyns, & Le Blanc, 2006). In comparison, relationships that are lower in LMX generally have negative implications. In these cases, supervisors view subordinates as hired hands, and thus they play smaller roles in subordinates' job experiences (Dansereau, Graen & Haga, 1975; Dienesch & Liden, 1986; Graen & Uhl-Bien, 1995; Scandura, 1999; Zalesny & Graen, 1987). These types of employees have lower degrees of job performance, less resource exchange and lower job satisfaction. Accordingly, in terms of micro-level implications for macro-level outcomes pertaining to firm resources (Foss, 2011), dynamic capabilities (Helfat & Peteraf, 2015), and firm performance (Felin & Hesterly, 2007), we believe LMX may be a powerful micro-foundation for further consideration and shedding light on microenterprises (i.e., Lumpkin, McKelvie, Gras, & Nason, 2010) and small businesses.

We set out to make the following contributions. First, we are seeking to use LMX relationships and their outcomes to explain how the owner-manager can produce better outcomes for small businesses. Second, although management expertise and skill has been a major consideration, scholars have been somewhat unclear regarding what actual behaviors and skills managers have in small business settings. Accordingly, we seek to add specificity to research in that we examine distinct relationships. Finally, we seek to extend LMX theory beyond groups to small business research by examining how LMX can affect firm performance.

Social Exchange: Assumptions, Economic versus Social, and Theory

The basic assumption of Social Exchange Theory (SET) is the idea that people are motivated in their relationships by estimates of reward and punishment (Homans, 1961). The assumption is that individuals act in a rational fashion and focus on increasing utility. Therefore, individuals will pursue relationships that they believe will provide profit and dispose those relationships that are not profitable. The SET equation has three distinct parts: profit, rewards, and cost. Exchange partners are motivated to maximize profit. Rewards and costs can consist of both tangible and intangible goods and material. Rewards are those benefits partners receive from the exchange. Rewards can range from financial incentives, affiliation behaviors, resources, support, and goods/services. Costs are those investments individuals place into relationships to receive potential rewards. Costs are like rewards, but the major difference is that costs are used to induce a behavior of one of the exchange partners. Partners are motivated to maximize rewards and minimize costs. As such, in the SET equation, rewards less costs equals profit.

If the relationship is profitable, then it is likely to continue in the future. If the relationship is not beneficial, one or both partners are likely to withdraw. The relationship will only likely continue if it remains profitable for both exchange partners. The more profitable the exchange, the greater the chance of exchanging in the future. For that reason, exchange partners who have a high frequency of exchange are most likely to have positive feelings towards the other partner. However, there can be too much of a good thing. At a certain point, the marginal levels of cost will exceed the marginal benefits of the relationships, turning a once profitable relationship into an unprofitable one.

One important consideration in social exchange, unlike economic exchange, is that social exchange benefits are acquired through diffusing future promises (Blau, 1964; Coyle-Shapiro & Conway, 2004). In an economic exchange, both the nature of the return and when the timeframe of the return are initially stated and then negotiated between the parties. According to Blau (1964), the prototypical economic exchange is a mortgage. The borrower and lender negotiate the amount of money to lend, the amount of interest, and the amount of time to repay. This is not a guarantee that the borrower will pay the amount back—defaults frequently occur—but there is an agreement to repay the lender. If the lender is not repaid, subsequent penalties accrue. Applied to the workforce, a subordinate may exhibit helping behaviors for the supervisor believing that the supervisor may reward them with favorable evaluations and work assignments (Dulebohn, Bommer, Liden, Brouer, & Ferris, 2012).

SET assumes that exchanges occur based on voluntary actions by two involved parties whose actions influence and reinforce the exchange. From Homans's (1961, p. 2) perspective, "when a person acts in a certain way he is at least rewarded or punished by the behavior of another person." Simply put, social exchange does not hinge upon if a husband buys his wife a dress, but instead upon if the husband expects to be praised or condemned by his wife for the purchase. Additionally, social exchange occurs neither through coercion nor formal rules (Blau, 1964). Furthermore, social exchange is concerned with actual behavior, not behavioral norms, because all rules, laws, and standards tend to be limited or unclear and as such cannot address every possible scenario. From a historical standpoint, Homans (1984) crafted social exchange as a means of explaining human interactions beyond basic norms or societal functions, and it is in this manner that scholars use it today.

Leader Member Exchange

LMX theory is the application of social exchange to supervisor/subordinate relationships (Graen & Uhl-Bien, 1995), defined as a social exchange relationship between a subordinate and supervisor (Erdogan & Liden, 2002; Liden, Sparrowe, & Wayne, 1997; Wayne, Shore, & Liden, 1997), with social exchange being the "general expectation of some future return, although its exact nature is definitely not stipulated in advance" (Blau, 1964, p. 93). LMX is the expectation that a supervisor and subordinate have of future returns. This type of relationship transforms the supervisor/subordinate relationships from spot transactions to the ongoing exchange of tangible and/or intangible resources (Blau, 1964; Emerson, 1972a, b). Unlike social exchange relationships, spot transactions tend to lack trust and mostly occur through negotiation (Bernerth, et al., 2007; Emerson, 1981; Muldoon, Singh, & Vidyarthi, 2019).

Conversely, appropriate benefits are generated by the involved parties' actions and are thus not negotiated initially in social exchange relationships. The time of return of said benefits is merely a future promise (Bernerth, Erdogan, & Bauer, 2015; Blau, 1964; Dulebohn, Wu, & Liao, 2017)). Consequently, managerial actions influence outcomes, and, in this case, also the activity or exchange of resources that occurs between a subordinate and a supervisor. The supervisor makes investments with certain subordinates, and based on the success of these investments, the supervisor gains social benefits related to social exchange. Thus, LMX is either the supervisor's or subordinate's judgment that participation in such an exchange will have beneficial outcomes: psychologically, socially, or economically (Homans, 1961). LMX goes beyond the dyad within larger organizational contexts: LMX impacts group and team performance as well (e.g. Hu & Liden, 2013; LeBlanc, González-Romá, 2012; Liden, Erdogan, Wayne, & Sparrowe, 2006; Schyns, 2006). LMX has also been related to the transgenerational sustainability in family firms (e.g. Memili, Welsh, & Kaciak, 2014; Pearson & Marler, 2010), whereas the future of the business is at least in some way predicated on the quality of interactions and a long-lasting, reciprocal stewardship culture. Akin to some family firms, small businesses possess a unique context where leader influence through interactions and exchanges can be most impactful.

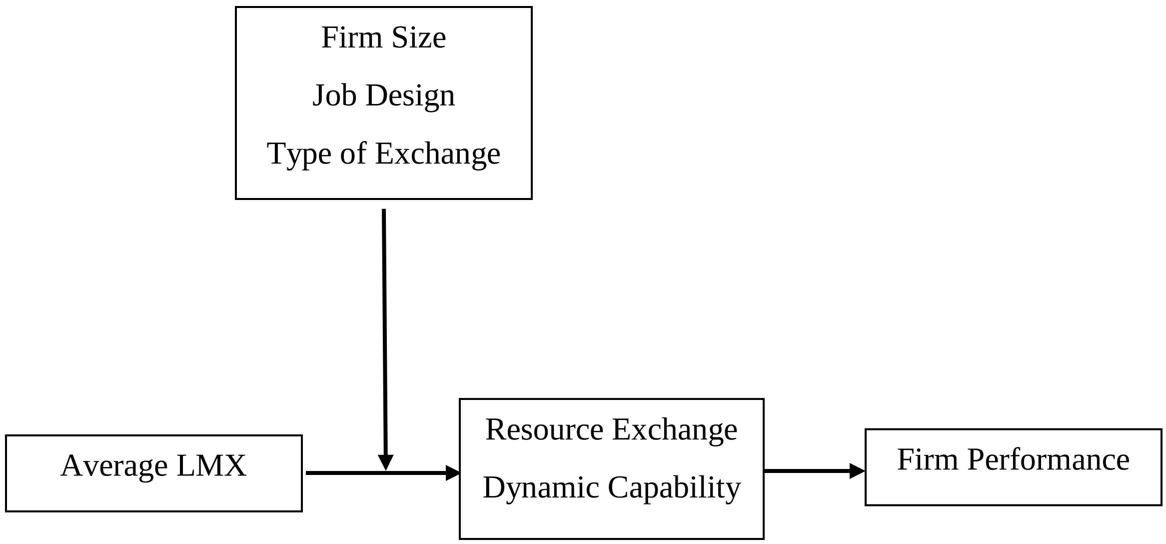
Most traditional research conducted on LMX has followed a dyadic approach yet noted that within complex work environments, this is not truly representative of the nature of leadership situations (Graen & Uhl-Bien, 1995). To this point, recent research contrives that the mean level of LMX quality (beyond dyads and within each group) is calculated via mean responses across group members (Bernerth & Hirschfeld, 2016; Yu, Matta, & Cornfield, 2018). Further, as Bernerth and Hirschfeld state (2016, p. 701), "… there is little reason to expect group members to demonstrate agreement on a variable that is theoretically unique from dyad to dyad (Ford & Seers, 2006; Liden et al., 2006). Thus, measures of within-group agreement were not calculated before averaging individual responses to the group level (see Cole et al., 2011), as average LMX represents an additive composition model (Chan, 1998)." This position is not uniquely new to the literature. For example, Graen and Scandura (1987) endorsed the LMX viewpoint of interdependent dyadic relationships, as opposed to the traditional independent dyadic style. While we acknowledge the dyadic foundations of LMX, we recognize the shift from a dyadic approach and seek to extend the theoretical domain of LMX into small businesses, as it parallels recent research from the group perspective.

Scholars assume that supervisors benefit from having better reputations, more promotional opportunities, improved health outcomes, and a more positive attitude about their own abilities (Liden et al., 1997; van Breukelen et al., 2006). Yet, the greatest resource that supervisors gain from the exchange is job performance (Dulebohn et al., 2012; van Breukelen et al., 2006). Since the primary role of the supervisor is to gain performance, these relationships are of prime importance (Gerstner & Day, 1997; Hogan, Curphy, & Hogan, 1994). In fact, the importance of supervisor/subordinate relationships within the organization intensifies in the current business environment due to the presence of reorganization, downsizing, and layoffs, which limits the social rewards and potential satisfaction individuals derive from the organization (Cappelli, Bassi, Katz, Knoke, & Osterman, 1997; Rousseau, 1998). Williamson (1984) noted that organizations encourage managers to see themselves as the personification of the firm. Hence, this could be a reason why organizational outcomes such as job satisfaction, organizational commitment, perceived organizational support, and psychological empowerment relate to subordinate-rated LMX (Dulebohn et al., 2012). LMX and its outcomes can lead to higher levels of performance from work groups, dyads, and organizations. Due to the smaller organizational size, greater opportunity exists for the potential of high-quality leader member exchanges as supervisors and subordinates are more closely linked to each other and organizational outcomes. Our purpose is to demonstrate the particular influence of LMX on small business outcomes that may not be nearly as relevant or available in the context of a large organization

Proposition Development

Our contention is that improved LMX relationships can enhance and produce a wide variety of resources, knowledge sharing, and dynamic capabilities through supervisor/subordinate exchange. More precisely, the subordinates' belief that they will receive benefits from their supervisor (e.g., pay, promotion, interesting work, etc.) will lead them to provide the firm with resources. A reason why a subordinate would provide resources to the supervisor would be, from their perspective, that the supervisor is a representative of the firm. In addition, the resources generated will lead to higher degrees of firm performance. Much like the supervisor/subordinate relationship described is predicated by the continual exchange of tangible and intangible resources, both tangible and intangible assets are positively associated with firm performance (Lee & Marvel, 2014). Given the theoretical linkage as described above, there are, however, situational boundaries such as job design, type of exchange, and firm size that will influence the relationship. For an overview of our theoretical model, see Figure 1.

Figure 1: Theoretical Overview of the Propositions



Resource Exchange

There are many definitions for resources. Since we are using social exchange as our theoretical basis, we utilize the typology of Foa and Foa (1976, 1980) to describe the resources exchanged. A resource, according to Foa and Foa (1976, 1980), is anything transmitted through one person to another. These resources have value through either the market or relationships during which the exchange of resources takes place. Resources are the benefits of the exchange and are why people exchange. However, gaining resources comes with a cost. If the cost is too great, the exchange will weaken; if the cost is sufficient, the exchange will stabilize.

Foa and Foa's general resource model is also useful in determining how managers aid workers; there are six general types of resources: love, status, information, money, goods, and services (1976, 1980). This group of resources is broken into two general categories. The first category refers to whether a resource is particular or universal. Particular resources are those that are unable to exchange with all others. For instance, love is not exchanged on the market. However, if a resource is universal, the resource has value regardless of who provides it (Foa & Foa, 1976, 1980); it can be bought and sold regardless of who is transacting. Money is a universal resource used by anyone to purchase nearly anything. The second category refers to concreteness which is how tangible or specific a resource is. A tangible resource such as gold is easily held or measured. An intangible resource is more symbolic or latent (i.e., status). Resources are conveyed in many ways and in many forms; managers have the ability to choose which resources to provide to workers in need.

Although there are many kinds of resources, the three general categories that we focus on are job performance, affiliation, and knowledge. A critical resource that a subordinate can provide is job performance. Scholars have expressed that there are different types of job performance, that is, in-role activities and organizational citizenship behaviors (OCB) Turnley, Bolino, Lester, & Bloodgood, 2003). In-role, focal job, or task performance includes "those actions and behaviors that are under the control of the individual and contribute to the goals of the organization"

(Rotundo & Sackett, 2002: 66). The second general type of job performance is an OCB. OCBs are discretionary, not explicitly rewarded nor recognized behaviors that lead to the strengthening of an organization's psychological and social core (Organ, 1997). The previous definition highlights two important concepts related to OCBs: they have value and are discretionary. There are three general targets for OCBs: the first target is the supervisor; the second target is co-workers; the third target is the organization (Lavelle, Rupp, & Bruckner, 2007). OCBs include helping behaviors, which occur when an individual takes on some of the responsibilities of another (Organ et al., 2006). Helping behaviors demonstrate higher levels of sportsmanship, civic virtue, and pride in the organization. OCBs are necessary for the social and psychological functioning of the organization because they aid in encouraging cooperation between various organizational agents, including supervisors and subordinates (Organ et al., 2006).

Another potential resource type is an affiliative resource such as job satisfaction, turnover intentions, or job commitment. All of these resources are important because they imply to both parties that the exchange is a positive one and will continue in the future. The satisfaction signalled to A is a sufficient reward for A to continue the exchange because A receives symbolic value from this exchange (Molm, 2003). This signal can be as subtle as a simple look. This measure of gratitude produces pride on the part of B upon recognizing that he/she produced a positive impact on A and this pride helps to produce future exchanges, since pride is a benefit that one can gain from the exchange (Lawler, 2001). Transaction exchange does not emanate from pride since neither trust nor liking is part of the exchange (Homans, 1974). These types of resources encourage exchange partners to continue the relationship since they originate from trust.

Knowledge is another type of resource that subordinates could exchange (Wilson et al., 2010). There is no consensus on the definition of knowledge, but a simple one is "that which is known" (Grant, 1996). Knowledge is also a resource potentially transmitted in a relationship, as well as created by relationships (Grant, 1996). This is especially true of tacit knowledge, not easily transferred in writing, but instead through an exchange in which both parties work together to produce some project (Emerson, 1981). The advantage that firms have over the market is that they have the ability to economize on communication through social networks (Arrow, 1974). The importance of knowledge comes from the specialization of knowledge for both organizational and mental perspectives (Grant, 1996). Yet social exchanges created by social capital within the organization, which is the relationships between individuals within the organization, can encourage both knowledge transfer and knowledge creation (Nahapiet & Ghoshal, 1998). As individuals exchange content and profitability, greater degrees of cohesion occur. Profitable exchanges eliminate the costs and power imbalances during ongoing exchange relationships. This is, in part, because through the belief of exchange and the anticipated belief of exchange, we expect increased levels of trust, which results in a willingness in both parties to exchange resources and overcome potential cultural and/or institutional barriers.

LMX relates to resource exchange because subordinates believe there will be future benefits from exchanging with their supervisors such that access will be gained through the benefits of relationships (Graen & Uhl-Bien, 1991; 1995). Mutual acquisition of benefits occurs through reciprocity, which is a process theorized to solidify social exchange relationships. Reciprocal exchanges produce conditions (Gouldner, 1960) that allow strong feelings to develop due to concurrent increases in trust and caring (Molm, 2003). Thus, reciprocity is a "vital principle of society" (Thurnwald, 1932, p. 106) because it is the key social process through which shared social rules "are enabled to yield social stability" (Gouldner, 1960, p. 161). Moreover, reciprocity is important since it is through reciprocal, repeated relationships (i.e., as opposed to transactional and economic exchanges) that individuals produce strong affective states (Homans, 1974; Molm, 2003). Based on their partners' willingness to reciprocate, individuals receive symbolic rather than mere utilitarian benefits. Symbolic benefits lead to a sense of caring in individuals toward their exchange partner, as well as greater confidence internally because their partner cares about them in return (Homans, 1974; Molm, 2003). Reciprocity is therefore a vehicle through which supervisors gain social benefits from social exchange relationships with subordinates (Molm, Collett, & Schaefer, 2007). These future benefits could include pay, bonuses, benefits, interesting work, and further employment. Since these benefits, offset the price of exchange, we believe they would induce the subordinates to provide a contribution. Accordingly, we propose:

Proposition 1: LMX is positively related to resource exchange.

Dynamic Capabilities

Dynamic capabilities are "the firm's ability to integrate, build, and reconfigure internal and external competences to address rapidly changing environments" (Teece, Pisano, & Shuen, 1997, p. 516). They are distinct from organizational operations, which is what the business currently executes. Rather, dynamic capabilities stress the potential of the business through modifying short-term competitive positions to become long-term competitive advantages. It is also distinct from the resource-based view of the firm, which focuses on what the firm could do in the present moment. Dynamic capabilities consist of what resources the firm should have in the future. Dynamic capabilities also engage the firm's competitors by allowing the firm to learn from competitors. In doing so, the firm is able to transform resources to meet ongoing needs.

The basis of dynamic capabilities is process oriented, with a focus on learning new assets and transforming assets (Winter, 2003). Learning refers to reorganizing activities to avoid potential blind spots and engaging new routines to create value through communication with customers and employees. Based on information from customers and employees, the firm can either acquire new assets or transform existing assets to match these new market needs. One of the ways firms can develop dynamic capabilities is through the effective, trust based exchange between managers, workers, and customers (Briggs & Grisaffe, 2010). This is exemplified by each partner recognizing others' needs and providing resources to encourage appropriate behaviors of improved routines and knowledge exchange that provides exchange partners with satisfaction (Jiang, Henneberg, & Naudé, 2011). In other words, the dynamic capabilities system hinges on social exchanges (Preikschas, Cabanelas, Rüdiger, & Lampón, 2017). As the small business requires increasing managerial information-processing demands, the social exchanges between supervisor and subordinate are magnified as critical factors in the dynamic capabilities system. Therefore, we argue that since LMX relationships serve as an important relationship in regard to workplace social exchange, the better the LMX relationship, the more likely dynamic capabilities will occur.

Proposition 2: LMX is positively related to dynamic capabilities.

Moderation

Social exchange relationships are moderated by outside factors, such as personal situations, types of exchanges, and the number of exchange relationships. Blau (1964) proposed that when an individual goes out on a date with someone who he/she seeks to impress, he/she will be more likely to tip a higher amount. Likewise, in relationships, situational factors will influence exchange relationships since they influence the cost/benefit matrix of the exchange. Scholars have proposed that the number of exchange partners, types of interaction, and types of exchange influence the exchange between partners (Emerson, 1972 a, b; Homans, 1950; Lawler, 2001).

Emerson (1972a, b) defines a social exchange relationship as an ongoing interaction between actors A and B, in which this interaction is a mutually reinforcing series of exchanges that is profitable for both actors. Furthermore, Emerson notes that this exchange relationship occurs within a larger exchange network, which is a series of opportunities for exchange between more than two actors. An exchange network will be present when actors A, B, C, etc. are present, rather than just A and B. In this case, the benefits that a supervisor would gain from a subordinate are based on the supervisor's other exchange partners, such as his/her other subordinates and the relationship with his/her supervisor. The implication of this relationship is that the greater the exchange network (i.e., the more dyads and interlocking relationships), the greater the resources available for the supervisor to gain.

Yet, the development of resources takes time, energy, and effort (Homans, 1961). Each relationship that a supervisor has to maintain requires the supervisor to spend time monitoring each relationship and providing necessary resources (Homans, 1974). The time spent managing each dyad is prohibitive (Muldoon, Keough, & Liguori, 2017). Other exchange partners will influence what supervisors can gain from the exchange, since they are simultaneously sources and recipients of resources from the supervisor as well (Day, Sin, & Chen, 2004; Major & Morganson, 2011; Wilson, Sin, & Conlon, 2010). As the availability of exchange partners increases, the frequency of exchange with any one partner will be lower, and because lowering the frequency of the exchange influences what benefits supervisors can gain either instrumentally or personally from a source, the frequency creates problems tracking the resource to a single source (Homans, 1950; Lawler, 2001). Therefore, the supervisor will experience decreasing returns on utility due to the costs (time, monitoring, and resources) needed to maintain the dyad.

> *Proposition 3: Average employee LMX is positively related to a) resource exchange and b) dynamic capabilities moderated by firm size such that the relationship will be strong in smaller firms.*

Job Design

Job design is the specification of methods, relationships, and duties that a job would include. It describes the working conditions that a person would encounter on the job. The idea behind job design is to encourage higher degrees of satisfaction and commitment, which will create higher degrees of job performance (Hackman & Oldman, 1976). One of the aspects of job design is the relationship with the supervisor. Some job designs will feature a tremendous amount of interaction with the supervisor, resulting in an increase in resource exchange. These outcomes may range from internal (e.g., evaluation of the supervisor's ability to fulfil his/her organizational role) to external (e.g., evaluation of the supervisor's exchange partners). Homans (1950) proposes that the development of positive relationships and the related positive feelings of liking, respect, trust, and price are outcomes of individuals successfully engaging in social exchange. Homans also notes that members of established groups tend to spend a large amount of time with each other because they have a track record of successful social exchange and thus are reaping social benefits (Homans, 1950; Lawler, 2006). As Homans stated "the more frequently persons interact with one another, when no one of them originates interaction with much greater frequency than the others, the greater is their liking for one another and their feeling of ease in one another's presence" (1950,

p. 243). These sentiments will produce more exchanges (Homans, 1961), and knowledge transfer within multinational businesses is predicated on trust and informal relations within the company (Kostova & Roth, 2003). Accordingly, we propose:

> *Proposition 4: Average employee LMX is positively related to a) resource exchange and b) dynamic capabilities and is moderated by job design such that the relationship is stronger in jobs where subordinates and supervisors interact more often.*

Types of Exchanging

Process is how exchange occurs (Coyle-Shapiro & Conway, 2004). More specifically, process is how, where, and when resource costs/benefits are discharged between exchange partners (Emerson, 1981). There are several types of social exchange. The first, and most commonly researched one, is reciprocity. As Fiske (1991) notes, reciprocal exchanges of in-kind payments usually occur between equals rather than parties of unequal power or authority because coercion could be used to gain rewards in the latter situation (Molm, 1997). Thus, the relationship is balanced reciprocity due to the exchange of like resources. The reason suggested is that such a relationship entails a degree of closeness, which is a familiarity of consistent exchange and the development of dyadic dependence. In a reciprocal relationship, one party incurs costs, while the other gains benefits. The party that encountered the costs hopes for future benefits, relatable to enlightened self-interest in the small business context (Peake, Davis, and Cox, 2015).

Another type of exchange is an indirect exchange, which occurs when an agent provides resources to one actor, but receives resources from another (Emerson, 1981). A supervisor may use a chosen subordinate with whom he/she has an excellent exchange to gain benefits from other subordinates, suggesting a potentially more dynamic exchange sequence than scholars have previously speculated. In conducting a network analysis, scholars can track each subordinate's resource exchange to determine what he/she gives to the supervisor to further examine how supervisors use resources to gain the support and cooperation of their subordinates. An indirect exchange should produce greater levels of overall exchange. The reason is that the resources the subordinate and the supervisor possess should increase because they can acquire resources from other members of the network.

A third type of exchange is productive exchange, where exchange partners assume costs and benefits simultaneously. Both partners must exchange to enjoy benefits. As such, this type of relationship can only occur when high levels of trust exist. Positive feelings between partners in this type of an exchange should be high. An example of a productive social exchange would be two authors collaborating on a project. Both partners bring different skills and expertise to the project, jointly creating something that neither could do on their own. In other words, the exchange creates synergy. Accordingly, we propose:

> *Proposition 5: Average employee LMX is positively related to a) resource exchange and b) dynamic capabilities and is moderated by the type of exchange such that the relationship is stronger for exchanges that are productive, rather than indirect and then reciprocal exchanges.*

Mediation

Lastly, we present the mediating relationships stemming from average LMX. These are between resources and firm performance as well as between dynamic capabilities and firm performance. There is a long history in strategic management that links resources, specifically those that are valuable, rare, inimitable, and non-substitutable to various outcomes such as competitive advantage and firm performance (Barney, 1991; Peteraf, 1993; Wernerfelt, 1984). Meta analytic findings also generally support the notion that better resources lead to better performance. (Crook, Ketchen, Combs, & Todd, 2008). While LMX may lead directly to the performance of the venture, we believe the relationship will be stronger when first showing that LMX enhances resources and capabilities. Our rationale for this is because the relationships involved in average LMX of employees and supervisors resides in the micro-foundations of strategic management. We find this particularly likely given that goals and motivations of employees matter when creating value for the firm (Foss & Lindenberg, 2013). Yet while many micro-foundations of strategy, including dynamic capabilities, have received attention (see Felin, Foss, & Ployhart, 2015), dyads of LMX as a predictor of resources/dynamic capabilities, which subsequently enhance performance, remains less explored. Because better resources and dynamic capabilities may help small business performance (Zhu, Hitt, & Tihanyi, 2006), and coupled with our prior arguments that explain why average LMX enhances aspects of a firm's resources and capabilities, we propose that LMX may underpin an important means to enhance such outcomes. While the direct theoretical leap from better average LMX to better firm performance may be too large, we find resources and dynamic capabilities, as a mediator to this relationship, to fit into current mental models in the strategy literature and to be better coupled with our prior arguments that suggest resources and dynamic capabilities may be enhanced with better average LMX. Accordingly, we propose.

> *Proposition 6: The relationship between average LMX and firm performance is mediated through a) resources and b) dynamic capabilities.*

Discussion

Our purpose was to add to the growing literature on micro-foundations in the strategic management literature by focusing on the role of leadership in promoting and developing exchanges in resources for small businesses. Previously, scholars have examined types of leadership and supervisor abilities to explain how small businesses are able to survive and thrive. We continue this research using one of the most common leadership theories, LMX. LMX has the added advantage of embeddedness in social exchange, which scholars have argued is an important construct for the development of resources within the firm (Cropanzano & Mitchell, 2005). In addition, we furthered the LMX literature in that we have considered the role of LMX in promoting firm performance. Scholars have demonstrated that LMX leads to higher degrees of group, individual, and dyad performance but we have theorized that the positive exchanges produced by LMX will lead to higher degrees of firm performance for small businesses. We have selected small businesses, rather than larger firms, since in a small business a worker could expect to continue to have behavioral interaction with their supervisor, which is a necessity for social exchange relationships (Homans, 1961). We also selected small business as a means of theorizing because small firms have less bureaucracy and stated policies, making the role of managers ever more important.

Furthermore, we provided mediation, through resource exchange (such as job performance and social behaviors) and the development of dynamic capabilities. Our contention is that the value of workers, whether it is the application of their knowledge or motivation, is based upon their belief that their managers will reward them in the future. Accordingly, the principle role of managers is to ensure proper cooperation on the part of the workforce. We propose that this ability will be in part due to the manager's ability to promote social exchanges within their work force. Essentially, our model suggests that it is the perceptions of workers that dictate business survival, especially in a new and/or unfamiliar environment. The practical implication of the paper is the need for small business owners to encourage strong relationships with their subordinates. Although this implication is obvious, the actual process is not, and is something we have addressed in our paper.

In addition, we proposed moderating variables that will strengthen and weaken the relationship. Firstly, the amount of interaction between supervisors and subordinates will determine how strongly the relationship will be. If the job design features a tremendous amount of interaction between worker and supervisor, we could expect that the relationships will be stronger, since there will be more interaction, hence more opportunities to exchange. We also proposed that the number of workers in the company would strengthen the relationship, in that, the more workers present, the more potential for resource exchange. Finally, the type of exchange will help to determine the relationship. If the relationships are productive, whereby parties exchange different goods, we could expect the relationship to be stronger as well.

We readily acknowledge that our propositions involve multiple levels of analysis. In the empirical context of small business research, it is not uncommon for leadership constructs and firm level outcomes to be evaluated in the same research design (Dunne, Aaron, McDowell, Urban & Geho, 2016). High quality LMX relationships have been linked to employees' job performance, which ultimately improves organizational performance (Janssen & Van Yperen, 2004). LMX research has employed the usage of both subjective and objective measures of firm performance, where the leader's evaluation of the firm is used as the subjective measure reducing some concern over cross-level analysis (Zhang, Li, Ullrich, & van Dick, 2015). As the propositions herein move towards empirical testing, we encourage researchers to acknowledge the potential issue of multiple levels of analysis and explore a number of potential options when assessing performance at the firm level, including proxies of individual performance and subjective measures of leader-rated performance.

Future research is needed to examine what factors lead to workers believing that their manager enters into social exchange relationships with them. Scholars have researched these factors in large companies, and have found variables such as demographic similarity, personality and managerial behaviors, to be important. Are there other variables that could influence the relationship in a small business setting? For example, consider if small business owners are more likely to hire friends or friends of friends. This means a prior outside relationship could influence LMX, and then the model. In addition, future research is needed regarding other types of leadership styles and behaviors that could influence small business success in different cultural contexts, including transformational leadership, authentic leadership, and servant leadership. Are these relationships formed universally, or do cultural variables play intervening roles in perceptions of relationship quality? In addition, exchange relationships outside the firm, such as suppliers and customers are of importance as well. Knowledge search in and outside of the company can have differential effects on efficiency for small businesses in transnational contexts (Morris, Hammond & Snell, 2014). In conclusion, we hope that our paper commences a discussion of the micro-foundations for small business success.

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