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The Impact of Cultural Diversity on Small Business Strategy

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Abstract

Academic literature is rich with studies of small firms and of cultural diversity in the workforce—but very few academic studies have researched the intersection of the two. Academic research has looked at small firms and the factors that impact small firm performance, growth, and failure. Cultural diversity studies have included research focused directly on the degree of cultural diversity of firms regardless of size. However, the impact of cultural diversity on small firm strategy has not been extensively reviewed. The intersection of small firms and cultural diversity yields a number of interesting hypotheses. Specifically, this paper examines: (1) The level of managerial skill at diversity management has a disproportionately large impact on small business capability to develop competitive advantage out of diversity; (2) Niche-based cultural competitive advantage is stronger in small business than in large organizations; and (3) There is an inverse correlation between number of cultures and strength of diversity strategy in small firms—while the correlation is positive in larger firms that can handle more complex interactions.

Keywords: small firms, small business, firm strategy, diversity, competitive advantage

1. Introduction

Cultural diversity has become commonly accepted as a source of strategic advantage for companies (Chavan, 2005; Cox & Blake, 1991; Hartenian & Gudmundson, 2000; Gudmundson & Hartenian, 2000; Granell, 2000). Cultural diversity can create unique capabilities for an organization, such as market insight into niches or different ways of approaching problems. Firms are actively seeking out cultural diversity not just as a social good, but as a source of value to defeat competitors in the marketplace.

However, the study of cultural diversity's impact on strategy has not extended to the realm of small firms (Hartenian & Gudmundson, 2000; Gudmundson & Hartenian, 2000). Small firms hold a unique place in the academic world—simultaneously the most common form of business entity in our economy, yet underrepresented in academic literature. While the unique aspects of small firm strategy (compared to large firms) have been examined (Mintzberg, 1979; 1983; Porter, 1980; 1991; Rumelt, Schendel, & Teece, 1994), the impact of cultural diversity has not been extensively explored.

Because of certain unique aspects of small firms— flexibility, closeness to market, speed of decision making, lack of scale, lack of specialization, and lack of regulation and standardization—cultural diversity is expected to have a different impact on small business than it does on large business. This paper explores these unique aspects of small firms and explain how they might alter cultural diversity's impact on strategy relative to large firms.

2. Literature Review

2.1 Small Firms.

The classification for small firms (also referred to as "small businesses") are numerous and sometimes conflicting in the academic literature. Most researchers do share common characteristics for small firm, traditionally classified by its size of revenue per year or the number of employees. For the purposes of this paper, the definition provided by the United States' Small Business Administration (SBA) is accepted. The SBA identifies small firms as those with less than 500 employees (SBA Office of Advocacy, 2019).

Unique characteristics. While small firms can be seen as on a continuum with large firms, they actually have several unique characteristics that set them apart. The unique characteristics associated with small firms can be both beneficial and harmful to the organization (and are discussed below.) All of these unique characteristics come out of the sheer fact that these firms are small and not due to any industry-specific or geographic differences.

There are many advantageous characteristics, as small firms tend to display greater flexibility in developing and changing strategy, a strong capability to stay close to market trends, and rapid decision-making (Burns & Stalker, 1961; Mintzberg, 1979; 1983; Rumelt, Schendel, & Teece, 1994). For example, nimbleness is inherent in smallness. Because they have less decision-makers and less complex processes, small companies are able to be more flexible and faster than their larger counterparts (Mintzberg 1979, 1983, Rumelt, Schendel & Teece

1994). Small firms tend to be able to change their strategy in the face of changing market conditions because there is less to actually change– larger firms need to coordinate multiple complex functions, while small firms tend to only have to communicate to a handful of employees and stakeholders.

Moreover, small firms tend to be able to adapt their strategies and tactics to changing marketplace conditions and also have capabilities to stay close to their customers and markets. Because there are less people involved in information flow, small firms are usually able to assimilate information they gather into their decision-making process both faster and more effectively than larger firms (Mintzberg 1979, 1983, Rumelt, Schendel & Teece 1994). Large firms might gather more raw information from the market, but that information is not easily shared with everyone who needs it in the organization. Nor will the right people necessarily talk about it to synthesize conclusions from market data and take action. In small firms, it is much easier for everyone to internalize the same market information and problem solve around it.

However, there are characteristics that are disadvantageous as small businesses tend to lack benefits of scale, access of capital, and specialized skills (Mintzberg, 1979; 1983; Variyam & Kraybill, 1993; Wheelen, Hunger, Hoffman & Bamford, 2015). Small firms inherently lack scale by their very definition. They thus tend to have a higher cost base than larger firms and find low-cost strategies (e.g. cost leadership strategies) very difficult to implement (Porter, 1980; 1991). Small firms also generally lack the same access to capital that large firms enjoy (Ang, 1992; Jarillo, 1989; Petersen & Rajan, 1994; Stinchcombe, 1965; Vesper, 1990; Weinberg, 1994). Specifically, small firms find it difficult to access more than a small amount of capital, especially long-term capital, due to certain requirements of the capital market. Venture capitalists offer a few select firms large amounts of capital, but most of these have large aspirations of growth. Many small firms do have a desire to grow, and thus need to turn to banks for capital—banks which typically have a relatively low tolerance for lending to risky new businesses. Small firms are thus unable to seize opportunities that could facilitate advancement of the firm (e.g., acquiring needed resources).

Small firms also are inclined to hire employees that lack specialized skills. Their small resource pool normally forces employees to be somewhat of a generalist—doing roles across traditional functions such as sales, marketing, finance, and general management. Thus, the lack of job specialization prevents the firm from creating a competitively differentiated competency in certain areas (Mintzberg, 1979; 1983). Smaller firms also tend to have a loose division of labor since there are less formal practices, such as training or strategic planning, present (d'Amboise & Muldowney, 1988; Robinson & Pearce, 1984; Welsch & White, 1981; Wheelan & Hunger, 2003).

Furthermore, although all firms are subjected to policies like Equal Employment Opportunity and Affirmative Action within the United States, small firms may not necessarily be held to the same strict standardization or public scrutiny as large firms would face (Carrell, Mann, & Sigler, 2006; Tsai & Kleiner, 2001). This is because large firms are held to greater regulations and oversight (from the government and even the public) on the processes relating to both

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diversity incorporation and demographics.

Building Competitive Advantage in Small Firms. Competitive advantage is the capability of a company to sustain profits that exceed the average for the industry (Porter, 1985). A firm achieves their competitive advantage through an amalgamation of the type of generic competitive strategies (low cost or differentiation) as well as competitive scope (breadth of target market, which is either narrow or broad) (Porter, 1985; 1991). Small firms can follow all the same paths as larger enterprises for achieving competitive advantage, although their execution is often impacted by their size.

Specifically, small firms rarely pursue a strategy of being the lowest price player in a market. Without economies of scale, small firms will rarely be able to lower their cost structure (and therefore customer prices) far enough below competitors to gain market share (Hambrick, MacMillan, & Day, 1982; Woo & Cooper, 1981). Two notable exceptions where small firms might follow a low-cost strategy are fragmented industry structures and proprietary technology. Small firms may be able to gain cost advantage in a fragmented industry where no competitor can gain scale advantages (usually labor-based industries where no scale advantages exist) through operational excellence. Technology might also enable a lower cost structure if it cannot be replicated by larger players or other small firm competitors.

Broad differentiation is usually the most successful strategy if a small firm hopes someday to become a large enterprise (Wright, 1987). Board differentiation usually takes the form of a superior product, service, or delivery characteristic that many customer segments seek over competitor value propositions—for which customers are often willing to pay a premium. (Porter, 1980; Wright, 1987) Small firms who have this competitive advantage will often be concerned about maintaining their differentiated position during their explosive growth—because larger competitors will attempt to replicate the differentiation with deeper resources.

Niche (also known as “focus”) strategies are more commonly used within small firms than with larger enterprises (Dean, Brown & Bamfor 1998, Porter 1985). Small firms can more effectively tailor their offering to the needs of a particular customer segment than larger companies, who need to target multiple customer segments to achieve their large size—and inherently find tailoring more difficult because they cannot focus like small firms (Wright, 1987). Small firm niche strategies will usually have a differentiating factor that meets the needs of the specific customer segment; the factor could be a product feature, a sales channel, or an additional service that the customer segment values more than the rest of the market. Often, small firms can command a price premium within this customer segment, leaving the cost-conscious customer segments for larger competitors.

2.2 Cultural Diversity.

Researchers have been interested in cultural diversity, especially considering the emerging presence of racial and ethnic groups in the United States (Cox, 1994; Hitt, Miller, Colella, & Triana, 2018; Pitts, 2005). The racial composition of the American population is projected to significantly change in the upcoming decades. For example, the percentage of non-Hispanic white people will decrease in the United States, from 63 percent in 2015 to around 43 percent by 2060 (Hitt, et al, 2018). During this time, the United States is also expected to experience an expansion of Hispanic-Americans (from 17 percent in 2015 to 27 percent by 2060) as well as Asian-Americans (approximately 5 percent to 8 percent) (Hitt, et al, 2018). The demographic trends of the United States have also altered the labor landscape. Specifically, the labor force is experiencing an increase in diversity. As a result, the workforce is becoming "more balanced with respect to gender and race, particularly in the public sector" (Pitt, 2005, p. 616).

Since diversity is increasing, it is important for firms to recognize the need to hire culturally diverse employees and incorporate their diversity to effectively satisfy the target ethnic niche. In the United States alone, multi-cultural consumers are projected to become the numerical majority by 2044 (U.S. Census Bureau, 2017). Moreover, with an annual buying power of $1.3 trillion, African Americans in the United States are on par with the gross domestic product of the Netherlands, Indonesia and Switzerland. African Americans are also projected to grow their annual buying power to $1.5 trillion by 2023 in the United States (Grace & Scott-Aime, 2019)—thus proving that the multi-cultural consumer segment in not one for organizations to ignore. Cultural diversity in a business setting is typically seen in multiple dimensions including gender, race, nationality (national origin), and religion (Carrell & Mann, 1995; Cox & Blake, 1991). Cultural diversity is oftentimes explained in terms of ethnicity, which for McMillan-Capehart defines as "groups of individuals based on race and cultural origin" (2005, p. 489). Cultural diversity recognizes the "representation, in one social system, of people with distinctly different group affiliations of cultural significance" (Cox, 1994, p. 6). Therefore, this paper looks at small firms in the United States, with an employee base that includes more than one distinct ethnic affiliation, as the aim of the paper is to explore cultural diversity in terms of its role and integration within organizations.

Firms may actively employ and incorporate a diverse workforce for many reasons. At the most fundamental level, some organizations are diverse to comply with federal regulations such as the equal employment opportunity laws as well as to avoid public scrutiny. Moreover, firms may turn to diverse workforces when the industries they function within experience labor shortages in their traditional labor pool (Hartenian & Gudmundson, 2000). More importantly, many firms today recognize that hiring employees with cultural differences and including their diversity is both a good practice to endeavor (Carr, 1993; Hartenian & Gudmundson, 2000) as well as also economically beneficially (Cox & Blake, 1991; Johnson, 1999). Hiring and retaining employees from various racial and ethnic backgrounds can help firms better understand and serve an existing diverse customer base, as well as attract potential future diverse customer bases. By understanding the needs of various communities, diversity can help organizations build a strong competitive advantage (Hitt, et al, 2018).

Cultural Diversity and Competitive Advantage. While cultural diversity has societal benefits, it also has benefits for businesses in building competitive advantage. Research has discussed several benefits firms receive from increasing its cultural diversity (Hitt, et al, 2018; McMillan-Capehart, 2005) including positive impacts on problem solving (Watson, Kumar & Michaelsen, 1993), creativity (McLeod, Lobel & Cox, 1996), productivity (Richard, 2000), competitiveness (Cox & Blake, 1991), and firm performance (Pitt, 2005). A culturally diverse workforce properly managed, and fully incorporated within the firm, can develop better understanding of customer segments and different perspectives that yield better decision-making (Gudmundson & Hartenian, 2000; Granell 2000). In today's heterogeneous society, customers have unique needs based on cultural considerations or values. For example, many immigrants from Latin America to the United States bring predilections for food and drink from their home country. Pepsi and Coca-Cola have recognized these preferences and developed beverages specifically tailored to the Hispanic market based on beverages from their home country (Hill & Jones, 2004). Having a diverse workforce is key to understanding these customer needs for a particular ethnic segment, as members of a particular community are best positioned to understand the needs of that community. At the same time, diverse perspectives and ways of approaching problems will help companies make better decisions—and cultural perspectives are one such way to bring diverse thoughts to problem solving.

Cultural diversity is also helpful with competitive advantage based in differentiation or niche strategies. Differentiation is possible when cultural learning is included in the service or functionality of a product. For example, many companies integrate ethnic themes into their mainstream products to create a differentiated position. Niche strategies are often the best way to build competitive advantage utilizing cultural insights or capability. Tailoring a company's products or services to an ethnic segment can build a sustainable advantage over competitors.

Success Factors in Building and Maintaining Cultural Diversity. The following five "key components" highlight the importance of the managers' role in firms. The managers' skillset in effectively performing and carrying out these five components will mean the difference in whether or not firms are successful in their pursuit to transform and maintain their organizations into culturally diverse firms. This is especially critical in small firms, where their size limits the number of managers and amplifies their role in the organization, while noting that managers lack specialized skills in favor of a more general skillset (Mintzberg, 1979; 1983; Porter, 1980).

Taylor Cox and Stacy Blake have identified five "key components" necessary to transform and maintain firms into culturally diverse firms (1991). The first component identified is "leadership," whereby firms must employ individuals who will become diversity champions. These champions not only identify the areas needing change, but also actively work with others to ensure the resources are in place for change to occur. The second component is "training" employees in regard to managing and valuing diversity. The training process is a continuous process that educates employees in how to be aware of diversity issues (e.g., stereotyping), cultural differences, as well as how to develop skills in reacting to differences at the office.

The third area focuses on "research" concerning diversity issues, which in turn aids the "training" process. Information gathered by the firm includes employee attitudes as well as equal-opportunity data. This information can also aid in recognizing and evaluating which areas require change within the firm. The fourth component is termed as "Culture and Management Systems Audit," whereby firms must perform an in-depth analysis of its culture and practices (e.g., recruitment, promotion) to expose any potential bias for certain groups as well as to identify how the firm positioned other certain groups at a disadvantage. The last component, "Follow-up," is comprised of the firm "monitoring change, evaluating the results, and ultimately institutionalizing the changes as part of the organization's regular on-going processes" (Cox & Blake, 1999, p. 54). This component requires firms to create processes for accountability and control in regards to creating and maintaining diversity.

2.3 Intersection of Small Business and Cultural Diversity.

Much like in other areas, small firms have unique characteristics when it comes to cultural diversity. The inherent characteristics of small firms make them stronger than larger businesses in leveraging cultural diversity to build competitive advantage—and weaker in others. It should be noted that for the aim of this paper (and for simplicity), small firms are referred to in the collective (all industries) without regard to specific industry in the United States. (This is a limitation of the paper which future research could address by investigating the differences in industries of small firms). Moreover, this paper is not looking at small firms consisting of homogenous groups of a single ethnic group (e.g. ethnic enclaves) but instead considering firms with an employee base consisting of more than one distinct ethnic affiliation.

Because the managerial talent pool in a small business is inherently limited in number, the actions of any individual manager are magnified. If there are only three managerial positions in a small company, the actions of any one is much more important to the firms' strategy proportional to the manager in the Fortune 500 company with thousands of managers. This magnification of individual impact carries over to diversity and managing cultures. If an individual in a small business is extremely skilled at managing diverse cultures, s/he is more likely to recognize the link on how to use those cultures to build differentiation or niche advantages. In larger firms, a manager skilled in diversity management is not likely to have a broad enough portfolio of responsibilities to see the link between the benefits of diversity and competitive advantage. For example, a small laundry shop owner dealing with customers every day in a diverse urban community could clearly see the benefits of multi-lingual employees to deal with various customer segments. However, a manager at a Fortune 500 manufacturing plant who deals with a specific aspect of an organization may not see how the diversity s/he manages can be best utilized to help the overall marketing division of the plant.

While the positive effects of a strong diversity manager in small business will add to their competitive advantage, there is likely to be a disproportionately negative impact of having weak diversity managers. Some managers of small firms may not possess the ability to deal with cultural diversity or be unable to translate it into a real competitive advantage. This is because small firms are more likely to employ managers that lack specialized skills (Mintzberg, 1979; 1983). Their small resource pool may force managers to take on a more general viewpoint on managing diversity as well.

Given the shallow talent pool in most small firms, if the manager is not able to effectively manage diversity and build a culture of diversity, there is no safety net of other talented managers with those distinct skills to alleviate that weakness. At a larger firm, a strong diversity manager may be able to compensate for a weaker one—but because of the lack of resources a small firm will disproportionately feel the impact of a bad manager. Therefore, this paper proposes:

> ***Proposition 1: Small firm culture-based strategic advantage will be disproportionally impacted by managerial talent relative to large firms.***

Smallness also brings with it closeness to the market. Focus (or niche) strategies are common among small businesses as they are more effective at tailoring products and services to the needs of a customer niche (Porter, 1980). Upper management at small firms have a better feel for the customer, as well as what their competition actions in the market are; while in major corporations information flow and decision-making is often several steps removed between customer and CEO (Burns & Stalker, 1961; Mintzberg, 1979; 1983; Rumelt, Schendel, & Teece, 1994).

Moreover, a culturally diverse workforce within small firms can be better positioned to identify opportunities in the marketplace. For example, it is easier for a small business to successfully understand and target a specific ethnic community than for a large conglomerate to penetrate that same small market successfully. Smallness provides the flexibility to focus resources on these ethnic markets, better communicate with the customer, and immediately translate needs to the rest of the firm. Therefore, this paper proposes that diversity-based niche strategies are also likely to be more successful in small firms than large organizations:

> ***Proposition 2: Niche-based cultural competitive advantage is stronger in small firms than in large organizations***

Having a limited managerial workforce also influences the number of diverse cultures that a firm can handle. Diversity looks very different when one is managing a few different cultures versus many different and unique cultures. Greater diversity tends to lead to greater competitive advantage as it enables more targeting of consumer segments (and therefore enlarging the consumer base for firms) and offers more perspectives in problem solving (thus increasing solutions that offer value to customers for firms) (Hitt, et al, 2018; McMillan-Capehart, 2005; Pitt, 2005; Watson, et al, 1993). However, managerial bandwidth and capability creates a bottleneck to this benefit.

Managing diversity takes time in order to effectively and appropriately understand different cultures, their nuances, and their unique strengths as they relate to the business or functional role of the employee. Managing diversity also takes a high level of skill to be able to both accept cultural differences while building a diverse group into a cohesive team. The literature recognizes that many small businesses lack both time and skill (Porter, 1985) as they employ a limited number of managers, many of whom might not have specialized skills (Mintzberg, 1979; 1983). Thus, an increasing number of diverse cultures in a small business may pose a greater challenge for small firms since there are not enough managers and resources to translate that diversity into an organizational strength or true differentiation (for each culture to be effectively represented in the marketplace). However, larger organizations are more likely to have the managerial bandwidth (with greater specialized skills) and resources to successfully position themselves for including multiple diverse cultures within their business strategy.

Thus, the third proposition is that there is a positive correlation between the number of different ethnic groups and strength of pursuing cultural diversity in the marketplace in large firms, while the opposite is true in small firms. Specifically, larger firms pursuing cultural diversity in the marketplace, are strengthened by having additional resources, including numerous manager who can effectively understand the difference and uniqueness of each group. Meanwhile, small firms will find it increasingly difficult to pursue greater cultural diversity into effective differentiation in the marketplace due to limited management (and skillset) and limited resources.

> ***Proposition 3: There is an inverse correlation between number of cultures and the strength of diversity strategy in small firms—while the correlation is positive in larger firms that can handle greater culturally diverse interactions as part of their firm strategy.***

3. Suggestions for Further Research and Conclusion

Given its inherent complexity, cultural diversity and small firm strategy are a largely unexplored arena that deserves more attention. The three propositions are offered in hopes to continue and expand the conversation around the impact of cultural diversity on small firm strategy. The purpose of this conceptual paper is to not only present these propositions in regards to the theory and academic literature, but eventually test them for future research.

Examining the impact of managerial actions on leveraging diversity for competitive advantage could be investigated through both qualitative and quantitative measures. Case studies of several small and large firms that have been both successful and unsuccessful in explicit diversity-based strategies could demonstrate the factors that contributed to success or failure (with the hypothesis being that manager action was a larger contributor to both success and failure in small firms). Moreover, small firm success rates utlizing diversity-based niche strategies could be measured in a more quantitative fashion. A population of small firms with explicitly stated diversity-based niche strategy could be measured against a similar population of Fortune 500 companies, with comparisons made of industry-adjusted success factors (e.g., ROIC, revenue growth, etc.). The number of cultures and success rates in diversity-based strategies can be measured quantitatively as well. A comprehensive study of small firms that utilized diversity-based strategies could include a simple correlation of the number of cultures present and the degree of success of the strategy (based on financial measures).

The subsequent step is to test these propositions as part of an overall research agenda on cultural diversity on small firm strategy. By transforming the propositions suggested in this paper into testable hypotheses, the hope is to initiate a discussion that will contribute to the existing base of knowledge about cultural diversity on small firm strategy. Specifically, the propositions presented here may have practical implications with how small firms operate but also how they manage cultural diversity with existing and new employees. It suggests that an ongoing discussion could benefit cultural diversity management, as well as the overall success of the organization. This paper attempts to shed light on the impact of cultural diversity on small firm strategy.

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