

Institutional voids and exporters' response: evidence from China

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Abstract

Trading companies have played significant and strategic roles in international trade. The transaction costs economics, indicated that the role of trading companies is to reduce the transaction costs during export. The local institutions, which are considered as main determinants on business models in transition economies, are most likely to affect the transaction costs during export, and trading companies' characteristics and their methods of reducing transaction costs. With six Chinese ETCs and their export processes as qualitative cases, this study identified four institutional voids associated with transaction costs for Chinese exporters and examine how Chinese Exporting trading companies (ETCs) responded to those costs and facilitated export between domestic manufacturers and foreign buyers.

Key Words: Trading Company; Transaction Cost; Institutional voids; Emerging Markets

1 Introduction

Trading companies are the earliest and most efficient facilitators for supporting local export (Jones, 2002; Perry, 1992). Being the "merchant" between manufacturers and foreign buyers, they are essential in international trade (Jones, 1998), facilitating manufacturers' exports (Peng & Ilinitch, 1998) and foreign companies' imports (Quintens, Matthyssens, & Faes, 2005). They support domestic manufacturers to search

for and negotiate with foreign buyers (Peng, 1998). They provide various services and supports for exporting (Balabanis, 2005).

Transition economies are defined as some countries and regions where formal and informal institutions are comprehensively and fundamentally changing, particularly from central planning to market-based economic reforms (Peng, 2003, p275). These economies are increasingly important for international trade. Different from developed economies with stable and effective institutions, however, transition economies experience a special period of mixed institutions (Nee, 1992), and result in a series institution-related problems (Child & Tse, 2001; Meyer & Peng, 2005; Witt & Lewin, 2007). Institutional void is one of the most important characteristics of such distinguishing institutional environment in transition economies. Institutional void means the absent of effective and efficient institutions, which support the normal market exchanges and functions (Khanna, Palepu, & Sinha, 2005; Mair & Marti, 2009). They considerably affect the business activities in transition economies.

Despite the increasing share of export from transition economies especially China, trading companies from these economies have been ignored by academics and practitioners for a long time. Their contributions to international trade are significant, yet little is known how they achieved these. Specifically, what are the particular institutional voids they face when they facilitate transactions between local manufactures and foreign buyers?

This paper aims to explore this key question. We combine institution-based view with transaction cost theory and identify the institutional voids that entail transaction costs associated with inefficient institution. An integrative approach is developed to examine the export-related institutions which generate costs for domestic manufacturers and foreign buyers in exporting activities. We use China as a case study. Despite the increasing role of foreign investors and local firms in contributing international trade, the trading companies still contributed to more than 30% of export in China (Yao &

Chen, 2001). There is a dearth of research of the characteristics, the business models and the institutional environments that Chinese trading companies face in the international trade. This paper aims to fill the gap.

The paper is organised as follows. After the introduction, the section two will review the relevant literature and develop an integrative approach. Section three presents the methods and data collection. Section four and five present the findings and discussions. Section six concludes.

2 Theoretical framework of trading companies and proposition

Terminology

Trading companies have received massive attention from academic, practical and political fields due to their significant role in international business. As the earliest economic organization involved in international trade (Perry, 1992a), they can be traced back to “colonial time” (Jones, 2002). They are defined in many ways. In this study, we use the broad definition as international trade facilitators and mediators through marketing, distributing and selling products overseas for manufacturers and through searching for and organizing suppliers for foreign buyers (Perry, 1992).

Transaction cost economics (TCE) perspective of trading companies

Transaction costs economics is the dominant theory in the studies of trading companies due to its powerful explanation of trading companies’ existence and business models (Casson, 1998). Coase (1937) originally points out the emergence of the firm arises from the costs of marketing transactions. Williamson (1979, 1985, 1988, 1996) further systematized TCE as a paradigm for analysing economic organizations. Bounded rationality and opportunism are two basic behavioural assumptions. The former indicates that individual behaviour is intensely but limitedly rational, while the later reflects the incomplete information and necessity of ex ante screening of agents and ex

post governance. Then, the transaction becomes the basic unit of analysis. Frequency, uncertainty and asset specificity construct three dimensions (asset specificity is the most important) of the transaction or contracting, and jointly determine different contracts and correspondingly different governance structures. The last point is the comparative approach (economizing transaction costs) to different transactions and governance structures. Williamson (1979, 1985, 1988, 1996) indicated that markets, firms and hybrid modes, as different government structures for organizing transactions, incur different degrees of costs, and the most efficient one can form.

International trade incurs numerous transactions and contracting issues among sellers, buyers and intermediaries, large risks and uncertainty, great information asymmetry due to different time zones, location and culture (Casson, 1998). Therefore, all these generate huge transaction costs for international trade. The trading companies, as the intermediaries for linking different players involved in international trade, effectively reduce these transaction costs and therefore facilitate international trade (Peng, 1998).

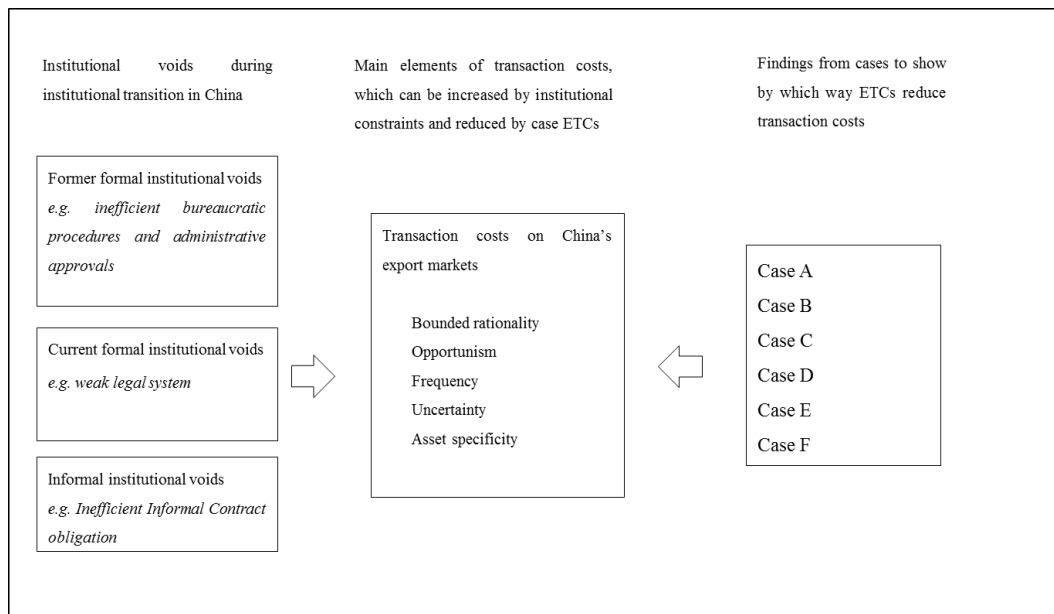
Institutional perspective of trading companies

Institutions, as the rules of the game, offer stable structure for human interaction. They contain formal rules, such as political, judicial and economic rules, and informal ones, like cultures, customs, traditions, and codes of conducts, which “come from socially transmitted information” (North, 1990, p37). The institutions influence transactions and the level of transaction costs. Most institutions researched are capable of reducing transaction costs, however, others, like “rules that restrict entry, require useless inspections, raise information costs, or make property rights less secure”, actually increase transaction costs (North, 1990, p61). Institutions become the combination of lowering costs and raising costs ones, due to imperfection of the market (North, 1990).

Such influences on transaction costs are variable for different organizations in the same institutional environment. It is common to state that institutions constrain certain

trading partners and transactions. At the same time, they facilitate others by enabling these social actors and actions and granting licenses and special powers (North, 1990; Scott, 2008). Therefore, we believe that the local institutions in transition economies will exert effects on export transactions among manufacturers and foreign buyers. Then, the trading companies can reduce the institution-related costs on China's export markets, while domestic manufacturers and foreign buyers fail to do so.

In addition, transition economies are the countries and regions where formal and informal institutions are comprehensively and fundamentally changing, particularly from central planning to market-based economic reforms (Peng, 2003, p275). The incremental institutional change gives rise to a special period mixing former and emerging institutions. Based on previous literature on transition economies (Peng & Heath, 1996), this study divides institutional voids into three main perspectives: former formal institutional voids, current formal institutional voids and informal institutional voids. In the end, the theoretical framework combining transaction costs analysis and institutional perspective is developed as below: three main groups of institutional voids create additional transaction costs, while ETCs are able to reduce them.



Theoretical framework in this study

Propositions

Institutional voids related to bureaucratic procedures and administrative approvals

Bureaucratic procedures and administrative approvals, as formal institution, is often labelled as an important institutional barriers for exporters (Kahiya, 2013). It is extremely true for Chinese exporters. With continuous influence from former central-planned economy, the government is still playing an important role in emerging market economy in China (Child. & Yuan, 1996). One serious problem is the superfluous business licenses and permits. Jia and Ling (2012) reported that Chinese exporters had to obtain many export-related approvals and permits from different government department for each export transaction. The application and process of such licenses and permits inevitably incur inefficient and less transparent bureaucratic administrative procedures (Estrin, Meyer, & Bychkova, 2008), which increase Chinese exporters' costs on money and time and make them less competitive. Moreover, it results in uncertainty for Chinese exporters. Similar to other emerging markets, fundamentally and continuously institutional transition towards market economy is a major characteristic of business environment in China (Buck, Filatotchev, Nolan, & Wright, 2001; Peng, 2003). It leads to unstable and changing government policy, therefore, to notable uncertainty. Massive researches have approved that unstable and changing government policies with institutional change largely raise uncertainty and problems for business in emerging markets (Bevan, Estrin, & Meyer, 2004; Estrin et al., 2008; Peng & Heath, 1996). In general, these government policies increase uncertainty and additional costs for Chinese exporters. Therefore:

Proposition 1. Chinese ETCs are able to reduce the transaction costs related to bureaucratic procedures and administrative approvals

Institutional voids related to the inefficient legal system and informal contract obligation

The inefficient legal system and contract obligations are another two institutional voids. Legal system is a major formal institution (North, 1990), and largely directly influence the transaction enforcement and related costs (Furubotn & Richter, 2005). China has the reputation of having a weak legal system (Child & Tse, 2001), which fails to efficiently protect property rights (Peng & Heath, 1996) and intellectual property (Beata, 2004; Child & Tse, 2001), and enforce contract (Luo, 2002), as raise opportunistic behaviours (Choi, Lee, & Kim, 1999). Furthermore, the informal institutions in China also enhance this situation. The absence and inappropriateness of formal commercial law in the history of China fails to construct a strong contracting spirit and obligation(Luo, 2002).

Exporting involved in many different organizations, including manufacturers, suppliers, middlemen, exporting intermediaries, shipment companies and forwarders, and therefore requires efficient cooperation among them. Inevitably such kinds of cooperation are based on variable contracts and formal and informal enforcement. A weak legal system with poor informal contract obligation incurs a number of problems on exporting, including products quality and timely delivery, most of which are reported as key barriers for foreign buyers' purchasing from China (LFRC, 2010; Nassimbeni & Sartor, 2006). In other words, many of current problems with exporting from China are actually contributed to two main institutional voids, weak legal system and poor contract obligation. Therefore:

Proposition 2. Chinese ETCs are able to reduce the transaction costs related to weak legal system

Proposition 3. Chinese ETCs are able to reduce the transaction costs related to inefficient Informal contract obligation

3 Research Methods

This study uses qualitative multiple cases study. First, the aim of this research is to explore the unknown Chinese ETCs and institutional environment, which is one “empirical investigation of a contemporary phenomenon” (Yin, 2003). China has become the top largest exporter, thanks to 30-years’ economic reform and export-oriented developmental pattern. In China’s Statistical Yearbook (SSB, 2014) of the same year, 43 % of this huge sum of exports comes from local manufacturers in China. However, many researchers argue that local manufacturers from these developing countries, like China, are suffering from many competitive disadvantages for their export strategy at the level of firms, industries and institutional infrastructure (Gao, Murray, Kotabe, & Lu, 2009). Meanwhile, the institutions, as a “real-life context” will be explored. These institutions and Chinese ETCs will be illustrated as a combination, which is in line with the statement that “boundaries between phenomenon and context are not clearly evident”. Therefore, this study believes that local institutions will influence the level of transaction costs in China’s export markets. More specifically, such influence will be shown as institutional effects on main characteristics of transaction costs in this study, say bounded rationality, opportunism, frequency, uncertainty and asset specificity.

The unit of analysis in this study is the Chinese ETCs’ export transaction *process*. The export transaction process is the unit of analysis in previous literatures on trading companies (Casson, 1998; Peng, 1998; Roehl, 1983), and transaction costs economics (Williamson, 1975, 1985). It also helps to focus on the institutions and costs on China’s export market during these export transactions process.

The in-depth and semi-structured interviews are main data collection method. The interviews are guided by a series of question lists and brief structure guide, and open-ended questions at the same time. These interview questions start with context-related questions, including historical and background information on the cases and

interviewees, and are followed by the questions related to the theoretical concepts, such as questions on whole exporting transaction process, specific transactional procedure and especially those on institutional voids, and conclude with the open-end questions on the interviewees' opinions on institutional voids in their exporting process.

In the timeline, there are three stages: pilot study A, pilot case study B and major case studies. The pilot study A is based on the interviews of domestic manufacturers, foreign buyers and Chinese ETCs, while pilot case study B is through Jia's two-month observation in a Chinese ETC (Case A). These two studies mainly offer the specification of institutional voids on China's export market in the early stage of research.

4 Findings

4.1 ETCs' response to costs related to the bureaucratic procedures and administrative approvals

It is found that the inefficient bureaucratic procedures and administrative approvals as the first institutional voids appear in all cases. Chinese exporters have to obtain a series of export authorities, business licences, and registrations for the start-up of export businesses. They have also to submit and/or receive a series of related documents/receipts to/from these relative government departments for each export transaction. These processes are complex, time-consuming and constantly changing, therefore reduce transaction frequency and generate additional uncertainty.

In turn, all case ETCs efficiently process bureaucratic procedures and administrative approvals. Their major method is to amass and master specific and updated knowledge (including information and experience) on these bureaucratic procedures and administrative approvals, such as the knowledge on how and where to apply for and register these official approvals and licences; about how, when and where to prepare,

submit and receive these necessary official documents to/from various government departments. This knowledge helps ETCs to increase transactional efficiency and frequency, and reduce uncertainty.

More specifically, this knowledge includes those about how and where to apply for and register these official approvals and licences as well as about how, when and where to prepare, submit and receive these necessary official documents to/from many different government departments. This knowledge is based on the presence of well-trained and experienced staff, and relevant routines embedded within the daily work of the ETCs. By mastering such knowledge, these ETCs efficiently process these bureaucratic procedures and administrative approvals with less time, resource-commitment and error rate. Thereby the transactional efficiency and frequency is increased. In addition, these ETCs frequently deal with these processes during their massive export transactions. Therefore they can also easily update their knowledge of the changes and new additions of the bureaucratic procedures and administrative approvals that ultimately reduce relative uncertainty.

4.2 ETCs' responds to costs related to inefficient legal system and informal contract obligation

The data from cases also shows that export transactions are extremely affected by China's inefficient legal system and informal contract obligation. All cases show the huge difficulties of enforcing export transactions, which are generated by opportunistic behaviours of domestic manufacturers. More specifically, these opportunistic behaviours refer to product quality problems (in cases A-F), production and delivery delay (in cases A-F), and breach of contract (in case C), which become the most significant problems of purchase in China's export market. But the local legal system fails to prevent it and turns out to be the most important cause of such situation, according to the interviews from the cases. Legal system neither protects other related

items with product from opportunistic behaviours. For instance, manufacturers could freely increase material price and illegally sell ETC's branded products to other buyers in Case B. Because of the worries about patent, ETC D establishes a self-owned manufacturer and only uses it to produce such related products.

In addition, the informal contract obligations in China are also problematic, and lead to many opportunistic behaviours and additional uncertainty. In all cases, the domestic manufacturers fail to efficiently enforce the export transactions according to their promise in original export contracts. These domestic manufacturers often freely receive orders without considering their capabilities, ignore the quality control and production schedule, and even intentionally raise prices, resulting in a series of problems during the enforcement of transactions.

In contrast, case ETCs in this study acquire massive amounts of information on production, which definitely reduces the information asymmetry between manufacturers and buyers, decreases opportunistic behaviours and uncertainty, and reduces enforcement costs. The information on production generally contains three aspects: current production conditions, production processes and products, and manufactures' characteristics. The information on current production conditions, such as the progress of production, enables Chinese ETCs to better control the production, including product quality and production schedule, minimizing the problems, and reducing the manufactures' opportunistic behaviours during the production process.

Moreover, the information on the production process and products, such as the quality control points on products and during the production process, increases the ETCs' capabilities for finding out and avoiding these opportunistic behaviours and uncertainty during whole production process. The information on products does not only refer to the quality, types and styles, but contains all characteristics of the product. For instance, in Case C, pricing becomes rather important information, which is systematically

collected, updated and used by the ETC to ease the uncertainty and manufacturers' opportunistic behaviours, and for re-negotiation post transaction.

Finally, the information on manufacturers' characteristics, which refer to the manufacturers' product quality, capacity, credibility etc, makes ETCs choose the most reliable and suitable manufactures according to their different foreign orders. In general, the information on production helps Chinese ETCs to reduce the information asymmetry, to reduce the possibilities of opportunistic behaviours and uncertainty during production, and finally to reduce the enforcement costs.

Institutions	Former formal institutional voids	Current formal institutional voids	Informal institutional voids
Institutional voids	Bureaucratic procedures and administrative approvals	Inefficient legal system	Inefficient contract obligation
Procedures in export transaction	The pre-export and post-export procedures	The procedure of enforcing manufacturers	The procedures for enforcing manufacturers
Specific examples	<ul style="list-style-type: none"> ● Licences and registration from various government departments to start export businesses ● Registration and approvals from various government departments for each export transaction ● Changing administrative procedures and policy ● Slow tax rebating system 	<ul style="list-style-type: none"> ● Quality problems ● Delivery problems ● Changed price 	<ul style="list-style-type: none"> ● Quality problems ● Delivery problems
ETC's methods for reducing such institution-related transaction costs	Knowledge (information and experience) of these bureaucratic procedures and administrative approvals	<ul style="list-style-type: none"> ● Information on production, including current production conditions, production processes, products, and manufacturers' characteristics ● Information on updated prices of product ● Vertical integration Brand, special certificates 	
How costs are decreased by ETCs?	By increasing frequency (dealing with more transactions than manufacturers), and reducing uncertainty	By mitigating opportunistic behaviour and uncertainty	

5 Discussion

In the past century, almost all socialist economies demonstrate a great deal of problems and are difficult to maintain, while other capitalist countries show more productive economies (Ingram & Silverman, 2002). With the increasing seriousness of problems in these economies, the transition from the former to latter is inevitable. The transitional process includes the collapse of previous institutions under the central planning system and the emergence of new institutions corresponding to the marketing system (Meyer, 2001b; Peng, 2003). But the process of replacement is incremental (North, 1990, p6; Peng, 2003), due to path dependency and bounded rationality. Therefore, a number of problems related to institutional transition take place in these countries. This section provides further analysis on findings with comparison of existing literatures on trading companies and transition economies.

Institutional voids

The bureaucratic procedures and administrative approvals, as additional processes, bear the typical characteristics of the central-planning system and become the formal institutional void. The transition of institutions related exporting in China, such as the export authority, has been underway since 1949 and up to the present day. During the transition, export-related institutions were changing from that of a wholly central monopoly, to one of relative decentralization among the state-owned economies, and then to recently relatively open and fair administrative procedures within private economies (Li & Liu, 2012). However, the transition and reform of these former formal institutional constraints is not completed, just relatively weakened, and has shifted from being obvious to invisible. Due to the nature of central-planning institutions, these bureaucratic procedures and administrative approvals still reduce the transaction efficiency on the current export market and generate additional costs for domestic exporters, especially for the emerging private and small-medium-sized exporters.

The potential explanation of domestic manufacturers' inefficient contract obligations can be two fold. On one hand, the inefficient formal legal system actually magnifies the potential for opportunistic behaviours of trading partners. The manufacturers behave opportunistically, as they feel free from such an inefficient legal system in China. For example, the domestic manufacturers get used to changing the agreed price, and breaking the contract, as they seldom face punishment from the legal system, or as they often only need to make some compensation to the buyers when they break the contracts (Case C).

On the other hand, affected by the tradition and culture, the contract obligation in China become distinct, and require trading partners to completely understand, and adapt to them, and therefore generate additional uncertainty for them. For instance, Wang (2005) indicates that Confucianism and communist ideology can cause citizens in China to ignore certain necessary institutions in marketing economies, such as private property rights. In addition, Luo (2002) argued that the commercial contracts, as part of the inefficient legal system in China, fail to efficiently enforce contracts in China. Instead, the contract obligations largely rely on other social norms, such as personal relationships. However, the tradition of relying on personal relationships will result in inadequate contract obligations in normal cases, and newcomers' will poorly adapt to such unique enforcement methods. As a result, it increases uncertainty and foreign buyers' enforcing costs. In short, the inefficient contract obligations also fail to efficiently enforce export transactions in China's export market.

The cost of enforcement contracts is one important sub-cost in transaction costs theory (Furubotn & Richter, 2005, p25), and is closely related to international trade in practice (Peng, 1998). The extant literatures on international purchasing and importing indicate that the quality and timely delivery of products become the most concerning problems for purchaser's decisions as to selection of suppliers (Kannan & Tan, 2002; Katsikeas & Dalgic, 1995; Leonidou, 1999). In China this condition, particularly the problems on unreliable supplier, on-time delivery and product quality, is even more significant

(LFRC, 2010; Nassimbeni & Sartor, 2006). The findings in this study echo these existing literatures. The enforcement of the export contract is one of the main problems for foreign buyers and trading companies. The inefficient formal legal system and informal contract obligation are the source of such problems.

Chinese ETCs' advantages on economizing these institution-related transaction costs

Knowledge, in term of information and experience, has always been the trading companies' advantages on economizing trade-related transaction costs. Peng & York (2001) state American export intermediaries' performance relay on their knowledge on foreign market and export process. Carlos and Nicholas's researches also highlight the significance of knowledge, information and experience on foreign markets for chartered trading companies (Carlos, 1992; Carlos & Nicholas, 1988, 1996). For Japanese general trading companies, information turn out be the most important determinant for their diversified businesses (Kojima & Ozawa, 1984; Young, 1974).

For this study, knowledge is the significant determinant for Chinese ETCs' advantages on economizing these institution-related transaction costs. First, for the first institutional void, the specific and updated knowledge on these bureaucratic procedures and administrative approvals play an important role. This sort of knowledge helps ETCs to increase transactional efficiency and frequency, and reduce uncertainty.

In addition, Chinese ETCs solve the inefficient legal system and contract obligations, by mastering the information on products, production and manufacturers' characteristics. One of their main methods is reducing information asymmetry. Studies from transaction costs economics have indicated that the uncertain and complex information, which generates bounded rationality, is the major reason for transaction costs (Williamson, 1975, 1985). Moreover, asymmetric information is the major reason for difficulty in identifying product quality and other resulting problems that

stop transactions, such as adverse selection and moral hazards (Akerlof, 1970; Stiglitz & Weiss, 1981).

Many studies indicate that the acquisition of information become an effective method to counter opportunistic behaviours, uncertainty, and relative high monitoring costs generated by local deficient institutions, such as the inefficient legal system, in transitional economies. For instance, Hoskisson et al (2000) believe that the information is useful for reducing monitoring costs in transition economies, where inefficient institutions increase opportunistic behaviours. Ahlstrom & Bruton's (2006) study also indicates that accurate information on firms, which is vital for venture capitalists to monitor funded firms' performance, is valuable and hard to obtain in emerging markets, along with the difficulties presented by the inefficient legal system.

6 Conclusion

In this study, four main institutional voids in China's export market were found, including, bureaucratic procedures and administrative approvals, the inefficient legal system, inefficient informal contract obligations, and long-term OEM trading methods. These four institutional voids bear the typical characteristics of transition economies, where formal and informal institutions are comprehensively and fundamentally changing, particularly from central planning to the market-based economic reform (Peng, 2003, p275). The bureaucratic procedures and administrative approvals and OEM trading method represent the formal institutions, which were inherited from the previous planned economy system (Estrin et al., 2008), but still exist in many forms during the period of the collapse of previous institutions under the central planning system, and therefore belong to the former formal institutional voids in the previous analytical framework. The inefficient legal system and contract obligations represent the lack of market-supporting institutions, which are hard to establish quickly, during

the stage of the emergence of new institutions corresponding to the marketing system in these countries.

Faced with these institutional voids in China's export market and related costs on export transactions, Chinese ETCs design efficient and effective methods to reduce these institution-related transaction costs. These methods highly rely on the acquisition of knowledge, in term of information and experience, on bureaucratic procedures, production, products and domestic manufacturers.

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