

2 Theoretical background

2.1 Theoretical framework: New Institutional Economics

The analysis of businesses between actors based in unstable institutional setups demands a theoretical basis that takes the omnipresent role of institutions into consideration. In the frame of the New Institutional Economics (NIE), institutions function as constraints and shape the behavior of economic actors.²¹ Following North, the NIE simply postulates: “[w]hen it is costly to transact, then institutions matter. And it is costly to transact.”²²

In analyzing the institutional framework conditions, the institutional environment is differentiated from institutions of governance.²³ The former concentrates on a broader view in line with North’s definition of institutions as rules of the game.²⁴ Displayed in the upper field of figure one there are formal constraints, such as rules and laws, and informal constraints, namely norms and culture of a society. The latter, in the center of figure one, is concerned with economic organizations and their resulting governance mechanisms, thus the institutional arrangements. The choice of the resulting governance mechanism is dependent on the level of transaction costs entailed by it. Hence, the design of the prevailing governance mechanisms shapes incentives and thus the behavior of the economic actors²⁵ who are depicted in the third layer.²⁶ Figure one proposes that the efficiency of differing modes of governance is shaped by, among other things, the institutional environment.²⁷

²¹ See North (1990), p. 97; North (2005; 1991); and Williamson (2000) as major contributions.

²² North (1994), p. 360.

²³ See Williamson (1996), p. 325.

²⁴ See North (1990), p. 4.

²⁵ See Steiner (2006), p. 202; North (1990); Picot/Dietl/Franck et al. (2012); Williamson (1996).

²⁶ See Williamson (1996), p. 325.

²⁷ See Williamson (1996), p. 223; Williamson (2000; 1998; 1981; 1975).

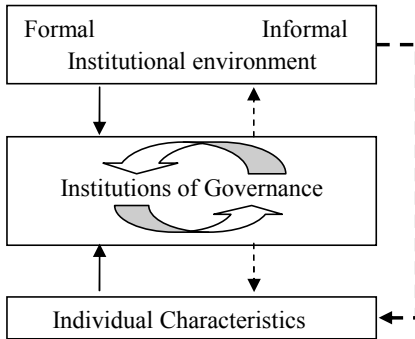


Figure 1: Three-level scheme of the New Institutional Economics
 (Source: *Williamson* (1996), p. 223).

Two different foci in the economic literature on NIE exist: While North (1990) analyses change in the institutional environment; Williamson (1996) takes the institutional environment as given and focuses on analyzing the governance level of economic organizations. The analytical framework of the research presented follows Williamson (1996) in taking the institutional environment as given.²⁸ Furthermore, this research is not meant to develop policy recommendations but rather aims at providing a practical solution for SMEs based in transition economies. Thus, it aims at a bottom-up approach of dealing with the institutional environment in transition economies rather than North's (1990) approach on analyzing possibilities to change the institutional environment.²⁹

In the NIE framework, behavioral assumptions play a fundamental role as they differ from the neoclassical approach. Individual utility maximization is the basic assumption in the NIE. Its origin lies in the idea that the individual actor, due to scarcity of resources, is constantly forced to choose between differing possibilities of resource investments.³⁰ Utility maximization implies that the actor chooses the possibility that maximizes his or her³¹ own utility, thus reducing the opportunity costs of the possibilities not chosen.³² Pursuing the assumption of

²⁸ See *Williamson* (1996), p. 5.

²⁹ See *North* (1990; 1991; 1994; 2005); *Alston/Eggertsson/North* (1996).

³⁰ See *Williamson* (1975), p. 26.

³¹ In this thesis, genders are in most cases based on the original actors and are non-judgmental.

³² See *Jungwirth* (1998), p. 12; *Picot/Dietl/Franck et al.* (2012); *Picot/Dietl/Franck* (2002).

individual utility maximization leads to opportunism, in which an individual actor is willing to harm others in order to reach his or her own goals.³³ The fundamental differentiator to neoclassic economic theories is the assumption concerning the level of information available to the individual actors. The NIE assumes, in reference to Simon (1957; 1991), bounded rationality, implying that knowledge and the capacity to process information is limited even though the economic actors are willing to act rational. Furthermore, implicit knowledge and the difficulties in communicating it have a negative influence on the rationality of the actor's decision. Institutions are seen as rationality surrogates to balance the missed increase in productivity originating from limited rational decisions.³⁴

2.2 Environments of institutional voids

With the NIE as a theoretical research basis, this subchapter will introduce the concept of institutional voids as an idea to analyze less efficient institutional environments and its applicability to transition economies. Beforehand, the main theoretical keywords are defined.

2.2.1 Defining the central concepts of competitive advantage, transaction costs and the institutional environment

For a better understanding of the discussion in this thesis, the main keywords are explained in short. For a deeper discussion of these keywords, the reader might refer to the cited literature.

Competitive advantage: Oliver (1997) discusses competitive advantage in the light of the new institutional economics from a resourced based perspective,³⁵ arguing that institutional capital is one of the resources contributing to the competitive advantage of a firm. She concludes that some institutional contexts allow

³³ See Williamson (1975), pp. 26.

³⁴ See Picot/Dietl/Franck et al. (2012), pp. 42.

³⁵ See Barney (1991); Grant (1991) and Peteraf (1993) for more details on the resource based view of competitive advantage.

for a more optimal use of the resource bundles than others.³⁶ Bresser and Millonig (2003) extent this approach and discuss three types of institutional capital as depicted in figure 2. Especially the regulative capital is of interest for my further research. Regulative capital is defined as denoting “competitive advantage that organizations generate when dealing with the formal and informal demands of external institutional actors.”³⁷ An organization possesses such, when it is capable of influencing “formal and informal rules to its advantage.”³⁸

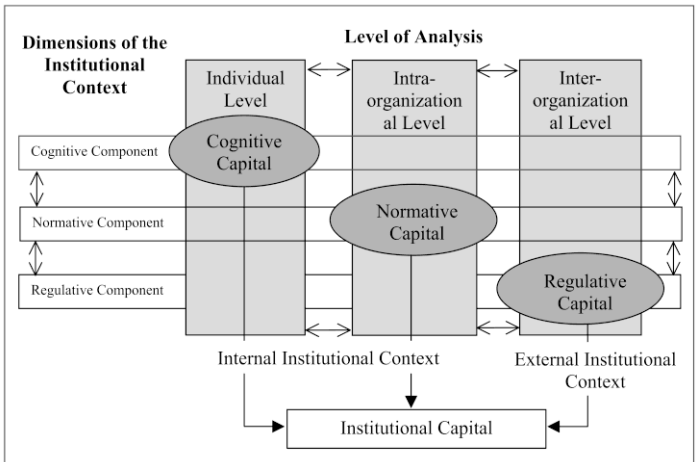


Figure 2: Institutional capital
(Source: Bresser and Millonig (2003), p. 229).

Porter’s (1985) defines competitive advantage as growing “out of the value a firm is able to create for its buyers that exceeds the firm’s costs of creating it. Value is what buyers are willing to pay”.³⁹ Hence, it is closely tied to the buyer’s value assessment and his resulting willingness to pay.⁴⁰ Porter (1991) also mentions that the institutional environment a firm is placed in influences its competitive advantage. He offers his diamond model to explore environmental advantages.⁴¹

³⁶ See Oliver (1997), pp. 710.

³⁷ Bresser/Millonig (2003), p. 230.

³⁸ Bresser/Millonig (2003), p. 232.

³⁹ Porter (1985), p. 3. For more details see also Porter (1986).

⁴⁰ See also Picot/Dietl/Franck et al. (2012), p. 262 and Porter (1991).

⁴¹ See Porter (1991), p. 12.

Even though, researchers of Porter's market based view often oppose the resource based view,⁴² this discussion will not be followed in this investigation. Porter's research on clusters will be discussed in more detail in subchapter 2.4.

Transaction costs: The behavioral assumptions detailed in the previous subchapter lead to incompleteness in contracting. Due to bounded rationality of the economic actors and the limited capacity to access and to process information, contracts are per se not complete.⁴³ To countervail, the economic actors create surrogates for rationality: institutions.⁴⁴ Similarly, the assumption of opportunistic behavior leads to safeguard mechanisms to ensure the reliability of the counterpart and the fulfillment of the contract.⁴⁵ Both, the incompleteness of contracts and the necessity of safeguard mechanisms entail higher costs, namely transaction costs.

Transaction costs economics is a major research stream within the NIE. The core unit of analysis is the transaction itself.⁴⁶ Transaction costs are defined as the "costs of running the economic system"⁴⁷ or even "the economic counterpart of friction".⁴⁸ They are the costs that arise due to coordination and motivation in the organization of an economic process such as the costs of obtaining certain information, the costs of contracting and its incompleteness, etc.⁴⁹ Transaction costs include all disadvantages and sacrifices, including non-monetary items such as the time a transaction entails. This includes not only the costs of arranging the transaction, but also the costs entailed by the negotiation, the costs of adapting and control costs.⁵⁰ In short, they are "measurement and enforcement costs"⁵¹ that influence the competitive position of a firm.

⁴² See Barney (2001); Makhija (2003) and Peteraf (1993) for a discussion.

⁴³ See Williamson (1996), p. 56.

⁴⁴ See Picot/Dietl/Franck et al. (2012), p. 42.

⁴⁵ See Williamson (1996), p. 56.

⁴⁶ See Williamson (1996), p. 234.

⁴⁷ Arrow (1969), p. 48.

⁴⁸ Williamson (1981), p. 552.

⁴⁹ See Coase (1937), p. 20.

⁵⁰ See Picot/Dietl/Franck et al. (2012), pp. 71.

⁵¹ See North (1990), p. 27.

Under the conditions of (1) asset specificity, (2) uncertainty and (3) frequency, the behavioral attributes of the actors have negative consequences on the economic outcome of a transaction.⁵² The specificity of an asset describes to what extent the asset can be used in another transaction. The higher the value difference between the use in the current transaction and the use in the next best option transaction, the more specific the asset. The specificity of the asset increases the incentive of the counterpart to act opportunistically. Concerning the second dimension; uncertainty countervails exact ex-ante agreements on all possible developments after signing the contract. This again gives room for the opportunistic behavior of the economic actor as it opens discretionary behavioral scopes. The frequency of a transaction is rather a subordinate condition. With increasing frequency of a transaction, the more depreciate the high investments and hence transaction costs as such.⁵³

Transaction cost economics is mainly based on Coase's observation that markets and hierarchies are alternative modes of contracting for the handling of a transaction.⁵⁴ Hierarchies, i.e. companies, are more efficient as long as the internal costs of motivating and coordinating the transaction are less than the costs entailed by a procurement of the transaction on the market. The advantages of 'hierarchy' lie in mutually acknowledged principles such as institutionalized incentives, sanction mechanisms, and eventual common resources. This countervails opportunistic exploitations of short-term advantages on the one side and reduces uncertainty on the other side. Thus, 'hierarchy' is preferable if the transaction is highly specific and uncertain whereas 'market' is the more efficient mode if the transaction is relatively stable and less intricate, as in this case, the actors benefit from diversification of risk and economics of scope. The more frequent a specific and uncertain transaction is, the more efficient the form of 'hierarchy' is as the investment costs depreciate.⁵⁵

⁵² See *Williamson* (1996), p. 45.

⁵³ See *Picot/Dietl/Franck et al.* (2012), p. 73-77.

⁵⁴ See *Coase* (1937), pp. 390.

⁵⁵ See *Picot/Dietl/Franck et al.* (2012), pp. 82.

Institutional environment: Formal as well as informal institutions evolve as rationality surrogates. Hence, the complexity of such institutions varies, depending on the complexity of the transaction they are supposed to simplify. The complexity of the transaction in turn depends on specialization and thus, the valuable attributes that need to be measured and enforced in the course of the transaction.⁵⁶ All in all, the institutional environment in which a transaction takes place influences the level of transaction costs since the institutions stimulate the structure of a transaction.⁵⁷

An institution might function as a rationality surrogate for one transaction and hamper another one in the meantime. For example, Maskell (2001) describes a case of the wooden furniture industry in Finland. The country, rich with necessary resources, lost its position to countries with far inferior resource endowments. The relevant Finnish institutions evolved due to activities of another important industry. Thus, the institutions were beneficial to this industry but hindered the furniture industry. Denmark, on the other hand, created an institutional setting that was so beneficial that the furniture industry could outperform its Finnish counterparts, even though it had to import the resources from Finland.⁵⁸ Recent empirical studies show that the institutional factors within a country have at least the same strong influences on companies' profitability as industry membership.⁵⁹

As North (1990) postulates "history matters"⁶⁰, he highlights the strong path-dependence of the evolution of institutions, which develop over time into an interdependent web of institutions that shapes the institutional environment.⁶¹ Since institutional settings shape economic behavior, an important task for policy makers is the creation of formal institutions that take informal norms into consideration.⁶² Based on the path-dependent evolvement of institutions, the institutional environment differs between countries, societies and regions.

⁵⁶ See North (1990), p. 34.

⁵⁷ See North (1990), p. 137.

⁵⁸ See Maskell (2001), p. 935.

⁵⁹ See Khanna/Palepu (2003), p. 13.

⁶⁰ North (1990), p. vii.

⁶¹ See North (1991), p. 107.

⁶² See North (1994), p. 366.

2.2.2 Defining institutional voids

According to North (1990), “institutions determine the performance of economies”⁶³, indicating that the key to superior economic performance is having efficient institutions. Efficient institutions are those that ensure the measurement and enforcement related to a transaction at the lowest possible transaction cost.⁶⁴ Transactions are generally more costly in environments where the institutional setup that is meant to foster transactions, such as contract enforcement and information provision, is weak.⁶⁵

This subchapter will provide detail on environments of less efficient institutional setups. The concept of institutional voids is introduced to specify certain aspects of such an environment before detailing on environments where such voids can be observed.

2.2.2.1 *The concept of institutional voids*

North’s (1990) discussions on insufficient institutions are from a macroeconomic perspective. Ricart et al. (2004) elaborate on ‘institutional voids’ to transfer North’s observations to a microeconomic level.⁶⁶ Institutional voids are basically lacks – or in North’s language ‘insufficiencies’ – in the institutional environment and generally “occur when specialized intermediaries are absent”.⁶⁷

Simplified, an intermediary is a “middleman” that connects economic actors that otherwise would not have been engaged in business.⁶⁸ An “intermediary is an economic agent that purchases from suppliers for resale to buyers or that helps buyers and sellers meet and transact.”⁶⁹ Therefore, intermediaries are actors that are to facilitate other actors’ transactions. According to Stulper (1996), depending on the industry and level on the value chain where the intermediary is placed, his

⁶³ North (1990), p. 137.

⁶⁴ See North (1991), p. 102 on descriptions and examples. This argument has been discussed in a similar way in Schrammel (2010c), p. 508; Schrammel (2013a), p. 115; and Schrammel (2013b).

⁶⁵ See North (1991), p. 102; Khanna/Rivkin (2001), p. 49.

⁶⁶ See Ricart/Enright/Ghemawat et al. (2004), p. 184.

⁶⁷ Ricart/Enright/Ghemawat et al. (2004), p. 184.

⁶⁸ See Peng/York (2001), p. 328.

⁶⁹ Stulper (1996), p. 135.

principal function is price setting and inventory keeping; thus, market clearing.⁷⁰ Randomly Stulper (1996) acknowledges the uncertainty and search cost reduction function of intermediaries in stating that intermediaries increase the benefits of the trading partners “by reducing or eliminating the uncertainty associated with making a satisfactory match”⁷¹ and “increasing the likelihood of encountering a trading partner and reducing search costs.”⁷² He mentions as well the information providing function of intermediaries in an environment with asymmetric information. He states that “intermediaries are better able to distinguish higher-quality suppliers from those with lower quality”,⁷³ referring to Akerlof’s (1970) ‘market of lemons’.⁷⁴ Stulper (1996) sees the high incentive of the intermediary for having more information in the reputation building aspect, as this would lead to more business. Thus, economics of scope seem to play a role, as the intermediary gains benefits from having several transactions in the same field.⁷⁵

Ricart et al. (2004) view intermediaries as “economic entities that insert themselves between a potential buyer and a potential seller in attempt to bring them together by reducing potential transaction costs,”⁷⁶ hence, facilitators that become necessary with the increasing intricacy of a business transaction. Three examples of specialized intermediates are named: (1) a contract guarantor, (2) someone or something providing specialized information and (3) an intermediary facilitating the search for trading partners, which is in line with Stulper’s observation above.⁷⁷ Khanna and Palepu (2003) detail on two further examples of intermediaries that appear suitable to insert; that of (4) talent search and of (5) capital provision.⁷⁸ Thus, intermediaries are institutions that act as surrogates for rationality in transactions in which, due to the behavioral assumptions adhere to the

⁷⁰ See *Stulper* (1996), pp. 137-145.

⁷¹ *Stulper* (1996), p. 145.

⁷² *Stulper* (1996), p. 145.

⁷³ *Stulper* (1996), p. 148.

⁷⁴ Cf. *Akerlof* (1970) for detailed information.

⁷⁵ See *Stulper* (1996), p. 148.

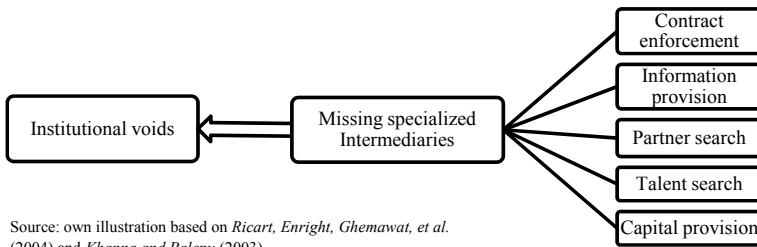
⁷⁶ *Ricart/Enright/Ghemawat et al.* (2004), p. 184.

⁷⁷ See *Ricart/Enright/Ghemawat et al.* (2004), p. 185. See *Khanna* (2002), p. 3 for more detailed examples such as venture capital firms and certification institutions.

⁷⁸ See *Khanna/Palepu* (2003), pp. 4.

economic actor, such as bounded rationality and disposition to opportunism, transaction costs are high or prohibitive.⁷⁹

The development of specialized intermediaries is mostly endogenous and depends strongly on political strategies and decisions. For example, literature observed, that specialized intermediaries on risk capital are more developed in India than in China. Chinese politics was highly supportive to the market entry of multinational enterprises into China. These MNEs do not depend on risk capital intermediaries within China as they have risk capital sources around the world. As the Indian government, on the contrary, did not facilitate the market entry of MNEs that strongly, the Indian economy is much more dependent on domestic enterprises. These are more in the need of domestic risk capital intermediaries.⁸⁰ Figure three summarizes Khanna's concept.⁸¹



Source: own illustration based on Ricart, Enright, Ghemawat, et al. (2004) and Khanna and Palepu (2003).

Figure 3: Khanna's concept of institutional voids

2.2.2.2 Discussions on the concept of institutional voids

Khanna made the term 'institutional void' known to a wider audience through numerous well-published articles. He discussed the connection to missing intermediaries and underlined the importance of regarding institutional voids in research on international management strategies. Nevertheless, Khanna's publications do not intend to develop a new theory of 'institutional voids'. Instead, his publications discuss business group performance and MNE strategies in emerg-

⁷⁹ The argument of this paragraph has been discussed in this or a similar way in Schrammel (2013a), p. 116.

⁸⁰ See Ricart/Enright/Ghemawat et al. (2004), p. 188.

⁸¹ This argument has been discussed in a similar way in Schrammel (2010c), p. 508; Schrammel (2013a), p. 117; and Schrammel (2013b). Figure 3 can also be found in Schrammel (2013a), p. 116.

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in transition economies

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