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Entry mode choice in China's regional distribution markets: Institution vs. transaction costs perspectives

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Abstract

In this paper, we investigate the entry mode choice of a leading Taiwanese food company in setting up regional distributors in China's 312 sales districts. Our study shows that, in entry mode decisions, the institutional factors are more important than transaction cost considerations. Both formal and informal institutions are considered. Formal institutions refer to government prescribed institutions (laws and regulations), while informal institutions refer to rules prescribed by the industry and the society. Both institutions are shown to affect the entry mode choices but one important type of institution, professional norms, is conspicuously missing in China. Professional norms exert peer pressures on the practitioners in the same profession, forcing their behaviors to conform to a common pattern. In the absence of professional norms, the roles of network ties and mimetic behaviors are heightened and they become a proxy for professional norms. As a foreign enterprise operating in China's local markets, the Taiwanese food company attained legitimacy by forming alliances with local wholesalers and by following its predecessors in selecting organization forms.

Keywords: Entry mode choice; China; Institutions; Transaction cost approach; Network relations; Mimetic behaviors

1. Introduction

Entry mode choice, which determines the ownership percentage and governance mechanism in business activities when multinational corporations (MNCs) operate in a foreign market, is vital to the survival and performance of the MNCs (Anderson & Gatignon, 1986; Shaver, 1998; Wind & Perlmutter, 1977; Woodcock, Beamish, & Makino, 1994). In the past, entry mode studies were investigated mainly on the basis of transaction cost theory (Anderson & Gatignon, 1986; Erramilli & Rao, 1993; Gatignon & Anderson, 1988; Palenzuela & Bobillo, 1999), with some being investigated using resource-based theory (Ekeledo & Sivakumar, 2004; Isobe, Makino, & Montgomery, 2000; Sharma & Erramilli, 2004) or eclectic views (Hill et al., 1990). Recently some scholars have adopted cultural and institutional perspectives to explore entry mode decisions (Brouthers, 2002; Kogut & Singh, 1988; Meyer, 2001; Yiu & Makino, 2002). In this paper, we propose studying the entry mode choice in a transitional economy, China, from an institutional perspective, and compare it to the transaction cost theory. Our aim is to find out which approach is more relevant to a transitional economy.

China launched its economic reforms as recently as 1978 after the demise of Mao Tse-tung and his style of command economy which emphasized collectivism. The business operations existing in China today are still deeply embedded in the

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institutions inherited from the command economy (Park & Luo, 2001). In a transitional economy, institutions are volatile and immature, exerting a large environmental uncertainty on foreign investors, particularly when considering the institutional environments established under communist rules that were drastically different from those in Western countries (Clague, 1997; Meyer, 2001). Even in developed countries, many scholars have found that the entry mode choice model would be more complete if the institutional environment were considered along with the transaction cost variables (Brouthers, 2002; Delios & Beamish, 1999; Yiu & Makino, 2002).

In the case of China, we postulate that the institutional theory can offer more explanatory power than the transaction cost model with regard to entry mode selection. This is because when entering a transitional economy like China, reducing institutional risks is a more important concern than enhancing efficiency on which the transaction cost approach has focused. By institutional risks, we refer to the risks caused by uncertainty or non-transparency of local institutions. We will not only examine the influences of formal institutions such as laws and government regulations, but also those of informal institutions. Informal institutions refer to rules and norms established by the industry or the society. Informal institutions are not bestowed with coercive power, but just like formal institutions, they restrain the behaviors of the relevant actors. We use the sales district as the unit of analysis, and our sample is composed of the entry mode choices of the regional distributors of Taiwan's largest food company, President Food Co., in its 312 sales districts in China locating in 267 of China's major cities. By studying the entry mode of the distributor in each sales district, we highlight the impacts of institutions, which vary across regions, on entry mode choice.

Today, China is widely known as the "world's factory" with a cheap labor force and an immense manufacturing power. Most studies on foreign investment in China have focused on the manufacturing aspects, but little research has been conducted on the marketing channels. By setting their eyes on the enormous market opportunities, many multinational firms have begun to explore the fast-growing domestic markets of China. This paper sets out to study the determinants of the entry mode choice of distributors in different sales districts in China. The paper offers two distinctive features: First, it studies the differences in regional institutions in determining entry mode choices in a single country for a single company; second, it highlights the importance of institutions even when the differences in national cultures seem to be small between the source and the host country.

We hypothesize that institutional environments are more important than transaction cost factors in determining the entry mode choice. To test the hypothesis, we will incorporate both institution and transaction cost related variables in the entry mode decision model and show that transaction cost variables are dispensable. Three sets of informal institutions will be assessed in our study: network ties, mimetic behaviors and professional norms. Network ties, known as "guanxi" in China, refer to personal and business connections which have been proven to be critical to business operations in China (Xin & Pearce, 1996). Mimetic behaviors refer to a tendency to follow the market leaders, the successful peers, or the predecessors originated from the same country (Haunschild & Miner, 1997). Professional norms refer to expectations about the behaviors that are shared by practitioners in the same professions (DiMaggio & Powell, 1983).

2. Theoretical background

Most previous studies on entry mode choice were based on transaction cost theory (e.g., Anderson, 1985; Anderson & Coughlan, 1987; Makino & Neupert, 2000). Transaction cost (TC) theory emphasizes economic efficiency in deciding the governance mechanism of a business engagement, but has been criticized for its oversight of the contextual grounding of human actions and therefore, leading to an under-socialized view of human behaviors (Granovetter, 1985). It was also criticized for its ad hoc behavioral assumptions which lack empirical evidence (Simon, 1991), for its failure to recognize the fundamental differences between an organization and a market (Ghoshal & Moran, 1996), and more commonly, for its lack of completeness in explaining the entry mode decisions (e.g., Zhao, Luo, & Suh, 2004). Recently, some scholars have introduced institutional theory (IT) to explore entry mode decisions. For example, Brouthers (2002), who studied European multinationals, found that entry mode choices that can be explained by an extended transaction cost model including institutional and cultural variables lead to better performance after entry compared to those that cannot be explained by the model.

Institutions provide the rules of the game for economic activities, by which the behaviors of economic agents are restrained (North, 1990). The rules of the game include regulations, customs, norms, and beliefs, which together shape the patterns of market exchanges (Davis, Desai, & Francis, 2000; Fligstein, 1996; Mols, 2000). Institutional theorists examine the constraining forces exerted by economic, social, and political institutions, with which the organizations have to cope in making decisions (Scott, 1995).

Whereas TC considers the finding, negotiating, and monitoring costs caused by information asymmetry and emphasizes the efficiency of exchanges (Oliver, 1991; Yiu & Makino, 2002), IT emphasizes the organizational legitimacy. Both theories are concerned with environmental uncertainty, but TC regards environmental uncertainty as an exogenous variable and a moderator in policy choice (Anderson & Gatignon, 1986; Williamson, 1981; Yiu & Makino, 2002), while IT regards uncertainty as something to be controlled internally by strategic actions. When entering an overseas market, TC focuses on the risks associated with transferring assets to a foreign location and the opportunistic behavior of the local partners, while IT considers the entry barriers originating from political and social constraints, and regards such constraints as the basis for inter-firm cooperation (Hitt, Ahlstrom, Dacin, Levitas, & Svobodina, 2004). TC emphasizes the diversity among transacting parties, while IT stresses uniformity in behavioral patterns and isomorphic pressures towards social norms (DiMaggio & Powell, 1983, 1991).

We argue that in a transitional economy IT offers more explanatory power than TC. In Western countries where institutions are stable, cost minimization and organizational