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**Integrating transaction cost and institutional
theories in an emerging market context:**

The case of the Tiger Leaping Gorge, Southwest China

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PhD

The University of Edinburgh

2010

DECLARATION

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Rawlence, S. (forthcoming) 'The challenges for tourism microenterprises in the Tiger Leaping Gorge, Southwest China' in *Contemporary Microenterprise: Concepts and Cases*, Munoz, J. M. (Ed) Edward Elgar, Cheltenham.

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ABSTRACT

The aim of this thesis is to explore the applicability of transaction cost theory to an emerging market context, and to complement it with institutional theory to achieve a closer fit. The research questions are:

- (1) Which causes of high transaction costs are perceived by firms in the research site?
- (2) How do they respond to these costs? The responses could range from internalisation, through cooperation, to the new concept of trading isolation, which is the first of two observed gaps in the literature.
- (3) Could an institutional perspective help to explain firms' responses, if they differ from what is expected by theory? The consideration of informal institutions with regard to transaction costs in China addresses the second observed gap in the literature, which focuses mostly on formal institutions.

Despite the strengths of transaction cost theory in identifying sources of friction in exchange and proposing resolutions, it has been criticised for making assumptions concerning behaviour and the strength of formal institutions that reduce the degree to which it applies in non-Western, emerging market research contexts. This thesis explores these limitations in the context of the inbound tourism sector in the Tiger Leaping Gorge, in rural Yunnan Province, Southwest China. The author's exploratory study had suggested that some of these firms attempted to reduce transaction costs by decreasing the number of transactions conducted, resulting in their relative isolation from – rather than integration into – a trading network. This hinders the firms' ability to develop and specialise, limiting their contribution to local economic growth in this relatively undeveloped region of China.

In the principal field study, qualitative data were collected through interviews conducted with the proprietors of the population of tourism firms in the research site.

The interviews sought to understand the transaction costs the proprietors perceived, their views of institutional strength or weakness (in areas including local government, legal system, financing, development of trust, kinship, *guanxi* and networks), and the ways they organised their firms. The data were explored first with a thematic analysis, then by coding into fuzzy sets for analysis with the Qualitative Comparative Approach to help identify causal associations between transaction costs, institutions, and responses of isolation from or integration into the market.

The main causes of transaction costs were found to be opportunism, uncertainty and bounded rationality. High transaction costs were generally associated with a response of isolation, but they were not the sole causal factor: every isolated firm reported weak informal institutions combined with a variety of transaction cost and formal institutional conditions. The difficulty of establishing new trust relationships increased the isolation of the worst-affected firms, in an environment where weak formal protection from transaction risks confined many firms to personal exchange.

A recommendation for local practice is made for firms to attempt to broaden the networks within which they develop trust, to reduce the constraint of personal exchange and consequent isolation. Two policy recommendations are made that could apply here and in emerging markets more generally: a mainstream recommendation to strengthen the enforcement of formal institutions, aiming to facilitate rule-based, impersonal exchange based on generalised trust, and an alternative approach deriving recommendations from the local context and including the consideration of informal institutions.

This thesis contributes to theory by highlighting the critical influence of informal social structures on the cost and extent of exchange, and adapting transaction cost theory to better apply to this institutional context. It also constitutes a novel application of the Qualitative Comparative Approach to interview data.

CHAPTER 1 INTRODUCTION

The aim of this study is to explore the applicability of transaction cost theory to an emerging market context, adapting it by means of integration with institutional theory to achieve a closer fit. This exploration is achieved through an investigation into firm-level behaviour, centred on the causes of transaction costs that firms perceive, the ways in which they respond to these costs, and the impact of the institutional context on their response.

Despite the strengths of transaction cost theory in identifying sources of friction in exchange and proposing resolutions, it has been criticised for making assumptions concerning behaviour and the strength of formal institutions that reduce the degree to which it applies in emerging market research contexts. The term “emerging markets” was coined by Antoine van Agtmael in 1981 (Peng, 2006), and it refers to economies characterised by high gross domestic product (GDP) growth rates, low GDP per capita, and economic liberalisation in progress (Arnold and Quelch, 1998). The further features of emerging markets that are recognised as impacting on business decision-making include the characteristics of undeveloped market institutions, weak legal enforcement, limited infrastructure, and political and economic uncertainty (Hoskisson et al., 2000). Conducting research in emerging markets offers an opportunity to “assess the generalisability and relevance of concepts and frameworks that have been accepted as universal... [in sites] overlooked or under-researched by management scholars” (Thomas, 1996: 493). This study explores these limitations in the context of the small firms engaged in the inbound tourism sector in the Tiger Leaping Gorge, in rural Yunnan Province, Southwest China. The rationale for the selection of this site during an exploratory study conducted by the author is presented in section 1.4.

The exploratory study suggested that some of these firms attempted to reduce transaction costs by decreasing the number of transactions conducted, rather than responding through the internalisation or cooperation anticipated by transaction cost theory. This appeared to result in their relative isolation from the market rather than their integration into a trading network. The exploratory study further suggested that some elements of the institutional context were limiting the options open to firms in their response to high transaction costs. The importance of this is that it hinders these firms' ability to develop and specialise, limiting their contribution to local economic growth in this relatively undeveloped region of China.

This chapter outlines the theoretical issue to be addressed, explaining why it would usefully be explored in the context of small firms in China's interior, and presents the theoretical and practical significance of this. It explains how a research site was selected, then sets out the structure of this thesis, and outlines the contributions it is expected to make.

1.1 The theoretical issue

The costs of conducting transactions have been compared to friction that increases the expense and delay of exchange (Williamson, 1985), and can occur during the specification and the enforcement of exchange (North, 1994a). Transaction cost theory was formalised by Oliver Williamson in 1975, and it considers the factors that contribute to high transaction costs to be bounded rationality, opportunism, asset specificity, transaction frequency and uncertainty. It further anticipates that firms will respond to high transaction costs by modifying the governance of individual transactions, and by moving towards integrated organisation structures; since the mid-1980s, the further alternative of adopting cooperative structures has attracted increasing research interest (Thorelli, 1986). Despite the strengths of transaction cost theory in explaining transaction governance and organisation structures in response

to transaction costs, it has been criticised from various angles – and it is these criticisms that this study seeks to address.

The criticisms that are central to this study concern the applicability of transaction cost theory to other research contexts, as management theories developed in the West cannot simply be assumed to be appropriate to emerging economies (Luo, 1997). Williamson's expectation that the transaction costs of bounded rationality and opportunism will uniformly lead to the internalisation of market transactions is strongly criticised as being inappropriate in Confucian countries that prioritise long-term relationships more highly than profit maximisation (Dore, 1983). The assumption of opportunism is further considered to overstate the rationale for internalisation in contexts where the market operates to remove opportunists (Hill, 1990). Both of these criticisms focus on the influence that different institutional contexts may have on both the level of transaction costs, and the ways in which firms respond to them. The enforcement of agreements at low cost is dependent upon sound institutions (North, 1990), which may not be available in emerging market contexts (Rao, 2003), and are recognised as being less reliable in China (Zhou and Poppo, 2008). This study therefore aims to respond to these criticisms by examining the applicability of transaction cost theory to an emerging market context, specifically China.

Within China the reliability of legal institutions, and consequently their effect on the level of transaction costs, varies by region and becomes weaker in the less developed provinces (Luo, 2007). Prior studies of transaction costs and institutions in China have focused on the industrialised coastal cities and provinces, for example Guangdong (Child and Moellering, 2003), Beijing and Shanghai (Zhou and Poppo, 2008), multiple coastal cities (Zhou et al., 2008), and Guangdong, Shanghai, Shandong, Zhejiang, and Zhejiang's immediate hinterland of Anhui (Peng and Luo,

2000). This study therefore seeks to make a fresh exploration of the costs and institutions in a less developed region of China's interior.

Transaction cost theory has further been criticised for offering an under-socialised explanation of economic action (Granovetter, 1985), by focusing on economic motives to the exclusion of social relations and trust. This study attempts to address this criticism by its consideration of informal institutions – including the structures within which trust can be formed, such as kinship ties and networks – as social influences on economic behaviour, and by its selection of a research site in which social relations might be expected to be very important to the conduct of business. Studies applying transaction cost theory to the Chinese research context find more evidence of cooperation than the other expected responses. Their authors explain this with reference to a range of both cultural factors and formal institutions, inviting further research into Chinese firms' responses to high transaction costs with particular regard to informal institutions.

The literature offers contradictory views as to the impact of the causes of transaction costs on small firms. Whereas Nooteboom (1993) observes that small firms incur higher transaction costs related to bounded rationality, uncertainty and opportunism than large firms, Granovetter (1985) expects small firms' networks of social relations to protect them from the risk of opportunism. This study seeks to understand more clearly the transaction costs perceived by small firms.

Transaction cost and agency theories are content theories, emphasising the outcomes of firms' decisions, as opposed to the processes by which they reach these decisions that are the concern of behavioural and organisational theories (Douma and Schreuder, 1991). Transaction cost theory employs comparative institutional analysis to evaluate the relative levels of transaction costs under alternative governance structures. The level of analysis for transaction cost theory is the organisation or the

dyadic relationship between firms engaged in an exchange, whereas agency theory analyses the behaviour of individuals, and behavioural theory operates within a single organisation. Whereas agency theory is concerned with the analysis of individual motivation, transaction cost theory places the individual into an institutional context, making firms rather than individuals the unit of analysis (Dietrich, 1994).

1.2 The exploratory study and the research problem

The author undertook an exploratory study at an early stage in the research programme. This was considered to be important in order to assess the feasibility of the proposed main study, as a certain degree of fit between theory and site would be required in order to produce interesting findings, but too close a fit would risk failing to make a new contribution. As indicated in the review of critiques of transaction cost theory presented above, a site was sought that represented an emerging market with a Confucian history, an uncertain formal institutional environment, an emphasis on social relations in business, that contained small firms and ideally was located in China's interior. The exploratory study took the form of an ethnographic reconnaissance (Wolcott, 1999), to facilitate an inductive exploration of firms' perceptions of the causes of transaction costs in the research site and their responses to them. The study first considered the practical feasibility of research in three sites, as will be described in section 1.4, and it then focused on one site in particular for this exploration of perceptions, which is the subject of Chapter 3.

This exploratory study found that transaction costs caused by uncertainty, opportunism and bounded rationality were perceived to be present, and it uncovered a form of response to transaction costs whereby firms' avoidance of (the high costs of) transactions led to their isolation from other firms. "Isolation" is used here to describe a tendency of some firms to rely on in-house production or limited volumes

of personal exchange for inputs, as opposed to trading widely and being integrated into a supply network, and as distinct from the theory's expected responses of internalisation and cooperation. The exploratory study suggested that high transaction costs were causing firms to become isolated from the market, in the absence of institutional mechanisms to reduce the transaction costs. This response has received little attention in the literature. Isolation delays the firms' integration into the market and the transition towards impersonal exchange that could enable further specialisation (North, 1990) and so increase the potential contribution of these firms to local economic development.

The study also suggested that institutions, both formal and informal, were important in shaping firms' choice of response. Internalisation was made difficult for foreign tour operators who were constrained by foreign-ownership regulations and the perceived risk to property, and domestic firms were hindered by limited access to financing. An example of cooperation between a local and a foreign firm was found, which benefited both firms (in the form of improved market access for the former, and reliable supply for the latter), but which appeared to lead to dependency on the foreign firm rather than a reciprocal relationship. In other cases, informal social structures such as kinship and networks appeared to be important to the conduct of business.

The exploratory study thus identified a research problem of the need to understand why firms that perceived high transaction costs responded with isolation, and how this response could be avoided. This in turn contributed to the shaping of research questions that would guide the more detailed investigation to be pursued in the principal stage of research. The questions are:

1. Which causes of transaction costs are perceived by decision-makers in the firms studied?

2. How do the firms respond to these transaction costs?
3. Could an understanding of local institutions help us to explain firms' responses to transaction costs?

1.3 The significance of the research problem

The significance of the research problem is now assessed with reference to criteria that were originally proposed by Level and Waters (1976), and which have subsequently been grouped into the two dimensions of theoretical and practical significance by Kittler (2009).

1.3.1 Theoretical significance

The theoretical rationale for pursuing a research problem is comprised of its contribution to a current research gap, its ability to sharpen the definition of a concept or the relationships between concepts, the scope for generalisation, and new contributions to data collection and analysis techniques.

The starting point for the theoretical basis of this study was the view that transaction cost theory may not apply equally well in all research contexts, suggesting an initial gap to be addressed by exploring the theory in a testing new context. This expectation of limited applicability was borne out in exploratory study by the firms that appeared not to respond to high transaction costs in the ways anticipated by the literature, which focuses on the internalisation of intermediate markets, and cooperation. There was little evidence of these anticipated responses in the exploratory study, as instead, the firms tended towards self-reliance and isolation from the market, which is touched on only very briefly in the literature. The influence of institutions on the level of transaction costs and firms' responses to them is considered in the literature concerning emerging markets including China, but is

very limited in its treatment of informal institutions in the Chinese context. The specific gaps addressed are thus the novel concept of isolation as a response to the high transaction costs, and the need for detailed attention to the impact of informal institutions in this context.

The literature gives slight consideration to the possibility that firms might avoid transactions whose costs are excessively high, and that where this is habitual it could result in the reduction of firms' participation in the market. The isolation that was observed during the exploratory study has been adopted as a sensitising concept for the principal study (Blumer, 1954), which is intended to expand upon this idea with reference to the firms' experience in order to result in a sharper definition that can more readily be deployed in future research. This study will also deepen our understanding of the relationship between transaction cost and institutional theories, which has not previously been achieved in such a way as to explain the influences of the institutional environment that result in the isolation that has been observed in this context.

Once isolation has been recognised as a current phenomenon in this research context, it seems likely that more instances of isolation will become apparent in future research seeking to explore it. We therefore consider this study's examination of the causes of isolation to offer scope for generalisation to other emerging market contexts with weak institutions, and from International Business to other disciplines such as Development Studies that share our concern with the potential contribution of private enterprise to economic development.

Although this study offers a theoretical contribution in its refinement of the concept of isolation, the author considers isolation to be not so much a new phenomenon as a relatively new subject of research. This suggests that the interview-based data collection method has contributed to more effective observation than researchers

may have employed in the past, and so the manner in which the study was conducted also adds to its significance. Furthermore, the use of the Qualitative Comparative Approach (QCA) for the analysis of interview data, and in the discipline of International Business, will later be discussed as a methodological contribution.

1.3.2 Practical significance

A research problem may be considered to be of practical significance if it addresses an issue that is of current and practical concern to a critical population, and can also relate to a wider population.

Isolation has the practical consequence of hindering the development of the small firms studied, as their reluctance to trade beyond the range of their trusted personal contacts prevents them from extending into impersonal exchange, which then constrains their ability to specialise and so benefit from increased productivity. This in turn carries significant implications for broader economic growth, which relies to some extent on the development of small firms, as will be discussed below. The exploratory study found this isolation to be a current phenomenon in the research site, affecting firms at the very time the study was conducted. The anticipated constraint on economic growth is also particularly timely in the period following worldwide recession. However, the currency of the problem does not equate with it being transient or of only temporary significance, as the need for development in the less-developed regions of China (see section 1.4.2) is a long-term issue which has no immediately foreseeable solution.

The population of decision-makers in the firms participating in this study is considered to be of critical importance to the research problem, because the decisions they make contribute directly to their firms' isolation. They perceive high transaction costs, do not enjoy institutional safeguards of impersonal exchange, and respond by

reducing the number of transactions they undertake, confining them to personal relationships – so their decisions work as obstacles to their firms' development. Any results of this study that help to explain the combinations of causal factors associated with isolation, and how they can be avoided, could be of direct benefit to these firms. However, a solution to the research problem would not be of exclusive relevance to the firms studied in the research context. The wider population to which the findings could apply includes firms suffering high transaction costs in the context of an emerging market with developing institutions, and even extends to all other participants of the focal economy to whose development the isolated firms contribute less than they might otherwise do.

Private enterprise is of recognised importance to economic growth and employment in general terms (Wennekers and Thurik, 1999, Morrison et al., 2003, Bennett, 2006), in rural economies (North and Smallbone, 1996) and in emerging markets where the growth of small firms in particular can be vital (Danis et al., 2010). This is of especial relevance to China, where the privatisation of a substantial proportion of the formerly state-owned sector makes future growth more dependent on private sector growth. An environment conducive to the growth of these large firms should also benefit small private firms, as a climate amenable to endogenous regional development would foster the growth of all firms rather than just those in receipt of special incentives (Pyke and Sengenberger, 1992). Adverse conditions such as high risk not only impose difficulty on small firms, but also reduce the extent to which they can participate in local development (Galbraith and Stiles, 2006); the Chinese Ministry of Commerce has announced expenditure intended to support the development of employment by small domestic firms (MOFCOM, 2008).

1.4 The selection of a research context

The preceding outline of critiques of transaction cost theory suggested that a challenging context for our attempt to apply and extend the theory would be an emerging market environment characterised by high transaction costs, weak formal institutions and an emphasis on social relations (suggesting a location in China's interior), in which small firms are engaged in international business. We therefore sought to meet these criteria by identifying a Chinese region within which the research problem could usefully be explored, before focusing on a province within that region where the criteria were present, and specifying an active sector of the province's economy within which to seek participating firms.

1.4.1 How Western China meets the selection criteria, and how the research could address its practical problem of surplus labour

It has been explained above that China's interior offers weak institutional enforcement. The Western provinces in particular are identified as posing a challenging environment for business (Luo, 1997), resulting in their attraction of only a fraction of China's inbound foreign direct investment (Loughman, 2007).

The West was the temporary focus of industrial development during the period of the first five-year plan (1953-57), when security concerns outweighed locational advantage. However, it was then eclipsed by the exclusive prioritisation of the development of the East, which was the focus of Deng Xiaoping's economic reforms in the 1980s.

The resulting developmental imbalance was recognised by the Chinese government, and the ninth five-year plan (1996-2000) included the aims of reducing the East-West disparity (Yan, 2003) and improving the West's infrastructure (Lin and Liu, 2008). This was continued into the tenth five-year plan (2001-05) with the launch of

the Western Development Plan, which was intended to upgrade the industrial structure and foster growth poles in the West (OECD, 2010). This plan has, however, has been criticised for delivering greater economic benefit to the East, through its perpetuation of the West's role as low-cost producer of natural resources to the rest of the country (Goodman, 2004). This view is supported by researchers at the Chinese Academy of Social Sciences, who have found a negative correlation between the development of the energy sector and economic development in the Western provinces since the launch of the plan (Shao and Qi, 2008).

To promote economic growth in the West and reduce the developmental imbalance, a shift has been recommended from this region-wide natural resource production to each province targeting its own comparative advantages (Lin and Liu, 2008). For Western China this would suggest labour- rather than capital-intensive sectors, due to the labour surplus that we will discuss below. Change is needed, as the current regionally unbalanced growth is not thought to be sustainable either in economic terms (Ding, 2007), or in terms of social stability (Shirk, 2007).

Another dimension of imbalance is between urban and rural areas, that further accentuates the development gap between East and West (Wan, 2008). Institutional weakness is a key differentiator:

Low accountability is linked with weak rule of law in the countryside. Courts are a key institution in turning the laws into reality, but they remain weak and have a low status in the political system (OECD, 2009: 32).

The problem is not insignificant, as 56% of China's population lives in rural areas, and China has the second-largest rural population in the world after India (OECD, 2009). Rural under-employment has been increasing ever since the decollectivisation of agriculture in the early 1980s, with its consequent vast increases in productivity (Riskin, 1991). Furthermore, in the 1990s the availability of funding for rural

entrepreneurship declined sharply, when 1980s policies to support rural capitalism were reversed (Huang, 2008). Kwan (2008) recommends improved rural education, to enhance agricultural labourers' prospects of alternative employment in the service sector, in rural areas. He describes rural-urban migration as "not entirely impossible, [but] institutionally difficult" (p27), because of the *hukou* or household registration system, which the government uses to "ensure that rural Chinese stay in rural China" and to control migration (Khanna, 2007: 193).

Whilst increased rural-urban migration could help to reduce the rural labour surplus in the future, it has already contributed to rural depopulation which in turn has raised the rural dependency ratio from 40.4% in 1982 to 43.2% in 2006 (OECD, 2009)¹. Rural income diversification is the recommended alternative, and private enterprise in export-oriented industry has already contributed to a "structural transformation of China's rural economy" (OECD, 2009: 21). This diversification needs to target non-farm employment in industry or services, because natural resource constraints diminish the possibility of agriculture continuing to employ its current 50% share of the Chinese workforce (Zhang and Wan, 2006). The New Socialist Countryside rural development policy of the eleventh five-year plan (2006 to 2010) aims to raise rural incomes (OECD, 2009), and our study's exploration of small, private enterprises in the rural service sector will contribute a possible means of reducing this practical problem.

A further criterion for selection of the research context was the importance of informal or social institutional arrangements to business. In the presence of weak

¹ For comparison, the UK's overall dependency ratio has remained close to 30% for the last 30 years (ONS, 2008).

formal institutions, firms in China use interpersonal networks or *guanxi* (connections, to be explained in Chapter 4) as an informal substitute (Peng et al., 2008). It then seems likely that in Western China, where formal institutions have been reported to be weak, firms will turn instead to informal institutions – supporting the expectation that Western China would make an interesting research site. The successful growth of small firms in the absence of strong formal institutions has been attributed to their reliance on informal institutions, in China in general (Yang and Temple, 2002) and in rural China in particular (Hu, 2007). Figure 1 below shows a map of China, and a dashed outline highlights Yunnan Province, which is discussed in the following section and for which a more detailed map is presented in Figure 3. The map also shows Kunming, the provincial capital of Yunnan, and Sichuan Province with its capital Chengdu, which will be referred to in later chapters.



Figure 1 Map of China, including provinces and provincial capitals

Source: Nations Online Project, reproduction permitted for educational uses.

http://www.nationsonline.org/oneworld/china_administrative_map.htm

1.4.2 How Yunnan Province meets the selection criteria, and how the research could address its practical problem of low income

Yunnan Province has a surface area over one and a half times that of the UK, with a population two-thirds the size of the UK's. It is China's most ethnically-mixed province, with only 66% of its population belonging to the Han Chinese majority (compared to 92% in China as a whole), and representing nearly half of China's 56 *minzu* or recognised minority nationalities (McCarthy, 2009). Yunnan is one of China's least-developed provinces: in 2007 it ranked 29th out of China's 31 provinces in GDP per capita (RMB 10540, or 48% of the Chinese average of RMB 21,973), and in the period 2005-07 its GDP increase ranked 24th (China Statistical Yearbook, 2008c). In 2001 only six provinces had less foreign trade as share of GDP (8% against China's average of 44%); 80.3% of Yunnan's industrial production was from state-owned enterprises (Western China's overall share is 70.6%, against 44.4% for China overall); and only two provinces had a smaller private sector (Goodman, 2004)².

Yunnan's rural areas are poorer still, whether disposable income is compared to the averages for urban Yunnan or for rural China, as illustrated in Figure 2 below.

Yunnan's mountainous terrain constrains its options for development, with limited amounts of land suitable for mechanised agriculture (McCarthy, 2009). There is thus little prospect of raising incomes through technical improvements to farming productivity, even at the cost of the lower employment this would require, so there really is a need for diversification away from farming.

² These comparative figures should be taken as an approximation only, as difficulties with official Chinese data include the use of different bases of calculation of apparently similar data.

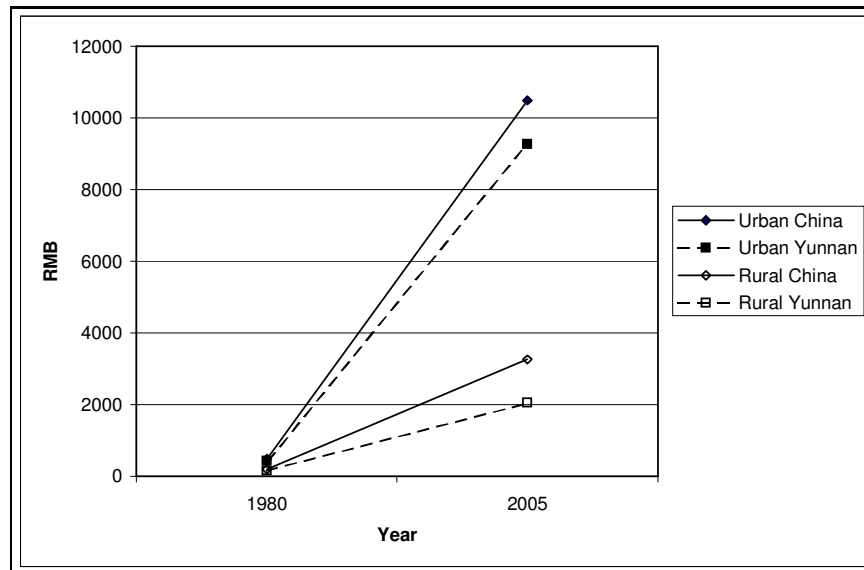


Figure 2 Disposable income per capita, China and Yunnan for 1980 and 2005

(Based on data from McCarthy, 2009)

Despite its low total income, Yunnan has been China's highest-earning inland or border province for inbound tourism every year since 2001 (when annual data became available), earning USD 860 million in 2007, representing an increase of 420% since 1995 (China Statistical Yearbook, 2008a). Overseas visitor arrivals in Yunnan increased from half a million in 1995 to 2.2 million in 2007 (China Statistical Yearbook, 2008b). This would suggest inbound tourism as a promising focus for the required non-farm employment, which could:

...promote economic diversification and a more *services*-oriented economy, ... opening up remote *rural* areas.... The fact that the consumer comes to the producer, rather than the other way around, enables even the smallest transaction to be part of the global economy: every sale to a tourist, be it a fruit or a haircut, represents an *export*. This constitutes an important opportunity, particularly for *small enterprises* (Barrowclough et al., 2007: xi, emphasis added)

Small enterprises have already made an important contribution to the development of China's private sector (Poutziouris et al., 2002). They could further be well suited to small-scale engagement with international tourism, whose invisible exports entail low start-up costs, and so can contribute to the development of a rural, service-oriented economy. China's tourism sector has been reported to be divided between domestic and inbound markets (Xu, 1999); the author found this still to be the case during her exploratory study in 2007, with firms focusing largely on either one of these two markets. Basing this study solely on the inbound sector was therefore considered to be practicable as well as theoretically desirable.

The potential for tourism to contribute to economic development is recognised by academic writers (Mowforth and Munt, 1998, Scheyvens, 2002), by the United Nations Conference on Trade and Development (UNCTAD, 2006), and by the World Tourism Organisation (UNWTO, 2005). Its particular relevance to rural development in China is also noted by academics (Xu, 1999, Zhang et al., 2006), by the Chinese Central and Provincial governments (UNWTO, 2006), and by the government of neighbouring Guizhou Province (Donaldson, 2007). However, in Yunnan tourism does not form part of rural development policy (confirmed in an interview with the Division Chief of the Yunnan Foreign Capital Poverty Alleviation Project Management Centre, a department of the Yunnan Provincial Government, in Kunming on 23/8/2007), but rather is considered to be like any other sector seeking to attract commercial investment (Yunnan Provincial Tourism Administration and UNWTO, 2001). There is thus scope for our study to enhance the contribution of local tourism firms to Yunnan's rural development, in the absence of guidance from other bodies.

1.4.3 Selection of a specific site within Yunnan

Investigation at the sub-provincial level is recommended for understanding economic and social interactions in China (Goodman, 2004). We therefore began to seek a site on a smaller scale, which had small firms engaged in inbound tourism, located in rural Yunnan. The initial screening for potential sites was conducted with reference to the itineraries offered by international tour operators, as sites included on these itineraries were clearly destinations for inbound tourists. Tour operators were chosen who claimed to support responsible tourism with an emphasis on local service provision, to further increase the chance that local firms were actively engaged in the business of inbound tourism. This resulted in a short-list of three possible sites in Northwest Yunnan: Lugu Lake, the Yubeng Valley near Deqin, and the Tiger Leaping Gorge. The author made an exploratory visit to all three sites in 2007 to evaluate their suitability as research sites for the main study, and to explore the compatibility between the proposed research questions and the chosen site (as will be described in Chapter 3). These sites are marked on the map of Yunnan Province in Figure 3 below. The provincial boundary is marked with a dotted line, and the area of particular interest has been highlighted with a dashed outline. This includes the three exploratory field sites, the Yangzi River and also the town of Zhongdian. Further locations marked on the map that will be referred to in later chapters include Lijiang and Kunming.



Figure 3 Map of Yunnan Province

Source: <http://www.chinaodysseytours.com/maps/Yunnan-maps.html>

1.4.3.1 Lugu Lake

The villages around Lugu Lake, which straddles the provincial border between Yunnan and Sichuan, have long catered to domestic tourists who are attracted both by the scenery and by curiosity about the matriarchal society of the indigenous Mosuo *minzu* (see Namu and Mathieu (2003) for a detailed description of family relationships and village life). Within the last few years, some entrepreneurs have begun to target the international market. Inbound tourist provision has grown, but is still limited to two or three enterprises per village. The addition of the tourism income to ongoing farming and fishing, in communities remote from institutional contact but presumably bound by close relationships, had seemed ideal during the planning stage.

However, the very friendly locals who had converted sections of their log-built, courtyard farmhouses for tourists were generally limited to simple communication in Mandarin Chinese. This was taught to schoolchildren as a second language, but severely constrained discussion with the author of the proprietors' approach to business. The recently established, purpose-built guesthouses in the lakeside villages of Lige and Luoshui were mostly owned and operated by non-local Chinese. Language was generally less of a problem in these cases, but a widespread reluctance to engage in conversation with a paying guest – far less a researcher wishing to conduct interviews – also hindered meaningful discussion. The author established that both types of tourist enterprise were family-owned, and that there was very little interfirm trading or cooperation. In fact, transactions of any kind seemed rare, with proprietors seeming almost surprised by the sudden appearance of customers. All of the cafés, guesthouses and souvenir shops bought the same packaged goods, in bulk, from the same visiting wholesaler from the market town of Yongning, so the author's planned discussion topic of supplier relationships reached data saturation alarmingly quickly. Beyond these businesses aimed at the perceived needs of tourists, there

appeared to be no commercial activity at all: a desire to buy locally-grown fruit or ordinary household items required a journey to Yongning, again curtailing the range of trading relationships that the author had hoped to discuss. The author found only one individual in possession of both local knowledge and a confident command of Mandarin, but in Yongning rather than the tourist area. His enthusiastic use of his social network to arrange accommodation and a trekking guide made him a promising candidate for the field study, but the absence of any others caused the author to dismiss this site.

It had also become apparent that travel between villages would become problematic if all were to be included in the principal field study. There was no scheduled public transport and independent travel by bicycle was made very slow by the incomplete circumference of the cobbled lakeside road. This joined up only those villages with designated tourist accommodation and excluded the villages that were home to the tourism employees.

1.4.3.2 Yubeng Valley

Beneath the peak of Kawakarpo in Yunnan's far northwest, the valley is reached on horseback or on foot by numerous Han Chinese and very few foreign tourists. The Tibetan villages had been overrun by the influx of hungry tourists and horses, the farmland had been turned over to grazing, and the locals spoke very little Mandarin at all. A helpful hotelier in the nearby town of Deqin had arranged for the author to meet the proprietor of one of the guesthouses in the valley, but in the event this proprietor was too busy to speak with the author for the duration of her visit. The site also turned out to have very little contact with inbound tourism, and seemed to be almost entirely dependent on immigrant labour: it was a poor fit with the selection criteria and was also dismissed.

Although both of the above sites are regularly visited by international tour groups, the local firms proved to be far from accessible to an unconnected outsider. However, the author had previously visited the third site on the short-list, so was confident of a more productive phase in the exploratory study. It was because of her earlier, fruitful trip to the Tiger Leaping Gorge that the author had thought it likely that the other sites could be feasible research sites, but the longer-term involvement of the former in tourism turned out to be of critical importance.

1.4.3.3 The Tiger Leaping Gorge

The Tiger Leaping Gorge is formed by the Yangzi River (known in these upper reaches as the Jinsha Jiang, or Golden Sands River) cutting a cleft 3,900m deep between Haba Mountain on its west side and the Yulong Xueshan (Jade Dragon Mountain) range to the East. Local farmers first began to take in foreign trekkers in the early 1990s, before the region had been officially opened to foreign visitors, and in the meantime have established a web of footpaths leading to their many guesthouses from which they generate a second income alongside farming. The gorge is popular with foreign trekkers who travel independently or with tour groups, walking the high-level footpaths that connect these guesthouses. Increasingly, it is also visited by Chinese tourists, most of whom travel the lower-level road by tour bus.

During the exploratory visit the author was welcomed by previous acquaintances, and succeeded in conducting interviews with these and more local businesses. Chapter 3 presents a detailed account of this visit, which resulted in the selection of this site, and specifically the west side of the Yangzi River (attached to Zhongdian County), from the town of Qiaotou to the village of Haba. The site met the criteria set for a site suitable for a detailed exploration of the applicability of transaction cost theory, which would then serve as the basis for future theoretical adaptation. It had

small firms actively participating in international business, in the sector of inbound tourism. This small-scale tourist provision appears to be compatible with the local resources and inhabitants, and “a significant portion of every yuan spent” in tourist expenditure directly reaches the local proprietors – unlike the mass-provision targeted at domestic tourists in Qiaotou and at lookout points on the lower-level road (Donaldson, 2007: 333). This reflects the investment-oriented approach to tourism in Yunnan: the construction of the low road was a government project entailing substantial capital expenditure, but requires frequent repair from landslides caused by timber harvesting and mining (Hayes, 2007), and the majority of the revenues generated accrue to the mining firm that controls access to it.

Whilst there are no data available for visitor numbers to the gorge itself because the sale of admission tickets is not recorded, the steady increase in the number of tourism firms in the gorge demonstrates growth. The relative success of tourism in the gorge, and more broadly Yunnan’s thriving tourism sector, suggest that this is an appropriate test-case (Yin, 2003): of all the sectors in Yunnan, tourism is most likely to be growing and yield interesting findings; if any site in Yunnan can foster thriving inbound tourism provision, the Tiger Leaping Gorge should be one of them; if firm development is hindered in this favourable context, we consider it likely that they would also be hindered elsewhere.

This site also had the additional benefit of the author’s compatibility. The author was able to communicate easily, established a rapport with several potential research participants, observed examples of high transaction costs, and deepened her knowledge of the site sufficiently to identify issues of real local concern to the local firms – including some institutional constraints that would perhaps help to answer the research questions. Two interviewees in particular confided to the author their

fears of a very uncertain future, as it was rumoured that the government intended to flood the gorge with a hydropower dam, but neither dared to protest.

1.5 Thesis structure

The structure and content of the thesis chapters are outlined below, beginning from Chapter 2.

2. Review of transaction cost theory

This chapter reviews transaction cost theory, beginning with the factors that are considered to cause high transaction costs, namely bounded rationality, opportunism, asset specificity, transaction frequency and uncertainty. It further considers the ways in which the literature expects firms to respond to high transaction costs, by modifying the governance of individual transactions and by moving towards integrated or cooperative organisation structures. These causes and responses are considered in relation to the research context, before critiques of the theory are presented which invite an examination of how well the theory applies in the chosen context. This focus on context offers an early indication of the importance that institutions will take on in the progression of this study. This chapter presents an illustration (Flowchart 1) of the literature's expected associations between the causes of transaction costs and responses to them, whose applicability to the research context is explored in the exploratory study.

3. Exploratory study and research questions

This chapter describes the aim, method and findings of the exploratory study undertaken by the author. The study took the form of an ethnographic reconnaissance, to explore behaviour related to perceived causes of and responses to transaction costs in the research site. The findings then contributed to the shaping of

research questions that were very much grounded in the context, and would both guide the more detailed investigation to be pursued in the principal stage of research and suggest a methodology appropriate to this.

This approach identified isolation from the market as a form of response to transaction costs that has received little attention in the literature, and suggested that institutions were important in shaping firms' choice of response. The resulting research questions are:

1. Which causes of transaction costs are perceived by decision-makers in the firms studied?
2. How do the firms respond to these transaction costs?
3. Could an understanding of local institutions help us to explain firms' responses to transaction costs?

4. Integrating institutional theory into transaction cost theory

This chapter outlines the development of institutional theory and introduces the distinction that is commonly made between formal and informal institutions. It discusses the benefits that the author hopes to achieve through combining transaction cost and institutional theories, in understanding the impact of institutions on the level of transaction costs, in shedding some light on the responses by firms to high transaction costs, and in adapting transaction cost theory to increase its applicability to the Chinese context. The particular features of formal institutions considered are local government, access to funding and the reliability of the legal system; the impact of informal institutions is considered in the areas of trust, kinship, wider networks and social sanctions. It identifies a second apparent gap in the literature, concerning the empirical study of informal institutions in China. This chapter presents a second illustration (Flowchart 2) that modifies the literature's expected associations between

causes of transaction costs and firms' responses, by adding the response of isolation that emerged during the exploratory study, and showing institutions as a possible moderating factor on the relationship between transaction costs and responses.

5. Methodology

This chapter presents the critical realist epistemology underlying this study, and it explains the qualitative approach taken to understanding perceptions of the causes of transaction costs, rather than quantification of absolute levels of costs. It introduces the fieldwork participants, who were decision-makers in 13 tourism firms in the selected field site. The participants' perceptions were explored during unstructured interviews conducted in Chinese, with questions relating directly to the transaction cost and institutional literatures (see Appendix 1). These were supported by context interviews with informed professionals and officials who were not directly associated with the field site. A thematic analysis of the interview data was conducted to seek answers to the first two research questions, whilst the causal complexity involved in answering the third research question was addressed by using the Qualitative Comparative Approach (QCA), a computer-assisted analytical technique that is based on the coding of interview data as fuzzy sets.

6. Thematic analysis and discussion

This chapter presents a cross-firm thematic analysis of the interview data, discussing participants' responses in relation to the literature of transaction costs and institutions, and to the context interviews. It answers the first two research questions, with the most commonly perceived cause of transaction costs being opportunism, and firms' responses including non-contractual transaction governance, organisation structures that were neither internalised nor substantially cooperative, and a general disinclination to specialise. The concept of isolation is explored in detail to address

the first observed gap in the literature, examining trading relationships up, down and along the supply chain, and isolation is found to be the most common response to high transaction costs.

This chapter also offers a preliminary answer to the third research question, prior to the QCA analysis and fuller discussion. Formal institutions are notable for their ineffectiveness, making internalisation an unlikely response in the presence of weak property rights and absence of funding, and cooperation is hindered by a lack of legal protection. The structures within which trust can develop are found to be vital in enabling and safeguarding transactions, but the process of developing trust is slow and selective, reinforcing patterns of personal exchange and further hindering cooperation. This begins to explain why firms try to reduce transaction costs by cutting down on the number of transactions, suggesting that high transaction costs and weak institutions contribute to the outcome of isolation.

7. QCA analysis and findings

The analysis presented in this chapter finds weak informal institutions to be a necessary cause of isolation, being present in all of the isolated cases. In contrast, formal institutions are not found to be causally important. The causes of transaction costs are combined with weak informal institutions to comprise sufficient causes of isolation.

8. Discussion

This chapter answers the third research question by finding the strength or weakness of informal institutions to be a contingent factor between the alternative outcomes of isolation from the market and integration into the market. Further exploration addressing the second observed gap in the literature suggests an underlying factor, that firms whose proprietors easily develop new trust relationships are more able to

overcome high transaction costs and avoid isolation, even in the presence of weak formal institutions. The implication is drawn that informal institutions are vital to the participating firms' avoidance of isolation, and that firms reporting weak informal institutions are more constrained in their response to high transaction costs. This chapter presents a third illustration (Flowchart 3), further modifying the author's expectation of associations between causes of transaction costs, institutions and responses, reflecting the QCA findings by reducing the emphasis placed on formal institutions and illustrating the moderating effect of informal institutions on the relationship between transaction costs and the outcome.

9. Conclusion

This study's contribution to theory is assessed in terms of its evaluation of the fit of transaction cost theory to the research context, and the increased applicability it offers by integrating transaction cost and institutional theories to better explain the response of isolation. It highlights the impact of informal social structures on the cost, extent, or even absence of exchange, and in particular, the constraint on trading imposed by the scarcity of trust. A recommendation for local practice is made for firms to attempt to broaden their networks, to reduce the constraint of personal trade and consequent isolation. Two policy recommendations are made: a mainstream recommendation to strengthen the enforcement of formal institutions, in order to facilitate rule-based, impersonal exchange based on generalised trust, and an alternative approach deriving recommendations from the local context and including the consideration of informal institutions.

This chapter presents a fourth illustration (Flowchart 4) indicating how the recommendations would be intended to increase trust, reduce transaction costs and enable more specialisation, and so increase the firms' potential contribution to economic growth. It is proposed that these recommendations could also be applied to

firms in other emerging markets that share the observed institutional weaknesses. The chapter concludes with an evaluation of the study, and ideas for future research.

1.6 Anticipated contribution

This study is expected to make theoretical contributions by addressing the two gaps in the literature, concerning isolation as a response to high transaction costs and the empirical study of informal institutions in a Chinese context. It will further integrate institutional theory into transaction cost theory, in an attempt to explain the response of isolation. It contributes to method in its approaches both to the observation of the phenomenon of isolation, and to the analysis of interview data in QCA.

The practical contribution of this study will lie in its deepening of our understanding of the factors that may hinder the development of firms in the research context, and in emerging markets more generally. The importance of non-agricultural growth to Western China and Yunnan has been explained, and the potential of the inbound tourism sector of the Tiger Leaping Gorge to provide it has been identified. Firms (in the gorge or elsewhere) that continued to respond to high transaction cost by isolation would need to meet their own supply needs through in-house production. This would hinder specialisation and increases to productivity, reducing competitiveness and in turn diminishing the firms' contribution to economic growth. This isolation also hinders any transition from personal to impersonal exchange, which could help to broaden the potential economic impact of trade, but would also be dependent upon impersonal trust based on dependable legal enforcement. The findings of this study could therefore contribute significantly to new approaches in policy and practice regarding the development of the research site and contexts similar to it.

1.7 Note on the use and romanisation of Chinese words

This study uses the contemporary Pinyin system for the romanisation of Chinese words, for the names of people and places referred to in the text. An exception is made for the names of Chinese authors, whose publications use the older Wade-Giles romanisation system. Thus, for example, the author cites Tseng and Kuo (2008) with the authors' names as they appear in the original publication, rather than converting them to the Pinyin form of Ceng and Guo.

This thesis follows the convention of the literature and the recommendation of Blenkinsopp and Pajouh (2010), of using the Chinese for terms that have no direct equivalent in English, and Pinyin is used for this purpose. For example, the term *guanxi* is usually translated as “social connections”, in the sense of using social, political or military connections to achieve personal or business advantage. *Hukou* is the system of household registration that makes it difficult for Chinese people to migrate away from the place of their birth. *Minzu* are the ethnic minorities officially recognised as nationality groups in China.

CHAPTER 2 REVIEW OF TRANSACTION COST THEORY

This chapter gives a brief overview of transaction cost theory, considering the causes of high transaction costs and the ways in which firms are typically expected to respond to them. This relates directly to the first two research questions that ask which types of transaction costs are perceived by the participating firms, and how the firms respond to them. It presents critiques of transaction cost theory that focus on its applicability to different contexts, and then considers studies that have applied the theory in research contexts similar to our own. This attention to context offers an early indication of the importance that institutions will take on in the progression of this study.

The emphasis of this study lies in the ongoing operations of firms as going concerns, rather than the influence of transaction costs on firms' market-entry decisions which forms a substantial part of the broader transaction cost literature. The chapter closes with an illustration of the literature's expected associations between the causes of transaction costs and responses to them, whose applicability to the research context is explored in the exploratory study described in the next chapter.

2.1 The costs

In 1937, Ronald Coase recognised the existence of and variation in the costs of conducting transactions, in a departure from the neoclassical economists' conceptualisation of efficient markets in which transaction costs were assumed be zero (North, 1994a, North, 2003). It was to be over three decades before Williamson (1975) would begin to formulate this into what is now known as Transaction Cost Economics (Jones, 1997, Klaes, 2008), at about the same time as New Institutional Theory also evolved (see Chapter 4).

Friction in transactions serves as a metaphor for transaction costs, causing delays and increasing the costs of exchange (Williamson, 1985). Transaction costs may be incurred both before (*ex ante*) and after (*ex post*) the transaction takes place: “Transaction costs are the costs of specifying what is being exchanged and of enforcing the consequent agreements” (North, 1994a: 361). *Ex ante* costs would include information search, the drafting of agreements or contracts, and negotiating prices, and *ex post* costs concern executing and monitoring the exchange, and enforcing the agreed terms. As such they may be borne by all parties to the transaction, and may vary between transactions and between contexts (Kreps, 1990). Rao (2003) considers a major part of transaction cost theory to be the economics of contracts under different forms of governance, focusing largely on the transaction costs of contract formulation and implementation.

Transaction cost theory describes the principal causes of transaction costs as a range of particular risks, and firms’ attempts to reduce them. The risks are bounded rationality, opportunism, uncertainty, transaction frequency and asset specificity. The theory proposes modified governance structures that firms may adopt with the aim of reducing transaction costs, in terms of both the risks and the associated contracting costs.

2.2 The causes of transaction costs

The aim of this section is briefly to describe the risk factors that are recognised as causing transaction costs, relating them to key references in the literature and to the first research question.

2.2.1 Bounded rationality

This is another departure from classical economic theory, specifically its assumption of the rational “economic man”. The concept of bounded rationality concedes that although economic actors such as business proprietors intend to behave rationally, this may be hampered by their limited (or “bounded”) information or ability to process it – the limited “access to information and the computational capacities” that humans have (Simon, 1955: 99). Bounded rationality affects the ability of these actors to make rational decisions, or increases the perceived transaction costs of making the decision, in specific ways including information asymmetry, planning, incomplete contracts, monitoring, and language.

Bounded rationality increases transaction costs if it results in “information impactedness”, a circumstance where one party has complete information that cannot be costlessly found out by the counterparty (Williamson, 1975). This has more recently been described as “information asymmetry”, and may increase risk to the buyer in his attempt to establish the “costs of measuring the valuable attributes of what is being exchanged” (North, 1990: 21), because he has less information than the seller concerning the good or service to be sold.

The limitations of human foresight serve as an example of people’s limited capacity for information processing, with the result that unforeseeable contingencies would entail prohibitive costs of “contemplation”, or planning and forecasting (Williamson, 1975). This idea is extended to the transaction costs of contract, in that ex ante costs are raised by contemplation of possible future events and their inclusion into the drafting of a contract, and ex post costs arise in interpretation or renegotiation when contingencies arise that had not been provided for in the original contract. The implication is that the transaction costs of contracting rise, as the parties to a contract attempt to make provision for contingencies that cannot be accurately foreseen due to

bounded rationality. The alternative is to economise on the transaction costs of contracting by accepting incomplete contracts, under which the parties expect to resolve contingencies as they arise (Williamson, 1985), thus reducing “the opportunity costs of the parties’ time spent writing the [complete] contract rather than doing productive work” (Milgrom and Roberts, 1992: 130).

Another impact of bounded rationality on contracts arises from the difficulty or cost of monitoring the counterparty’s performance. This is interpreted as a constraint on the effective enforcement of contracts when the costs of monitoring exceed its benefits (North, 1990), and as a hindrance to the drafting of contracts between parties who cannot easily monitor one another (Zhou and Poppo, 2008).

A further factor contributing to bounded rationality is language: if the nature of the transaction cannot be clearly communicated, the parties to it will have an incomplete understanding of it and the risks of bounded rationality will increase (Buckley and Chapman, 1998d). Buckley and Chapman expect that difficulties in communication will exacerbate the computational element of bounded rationality, and the author anticipates that this may be the case in the research context.

2.2.2 Opportunism

Opportunistic behaviour is described as “self-interest seeking with guile” (Williamson, 1975: 26), meaning an attempt to maximise one’s own welfare at the expense of others. Transaction costs increase when parties attempt to protect themselves from this risk of behavioural uncertainty.

Types of opportunistic behaviour anticipated in the literature include blatant lying, stealing, and cheating; breaking relational norms by making insincere promises regarding future conduct; and the deliberate withholding or distorted disclosure of

information that would be useful to others, thus contributing to information asymmetry (Williamson, 1985). Opportunism may occur *ex ante* or *ex post*, resulting in adverse selection and moral hazard respectively (Buckley and Chapman, 1998a). It may be active, meaning an action deliberately intended to take advantage, or passive in the sense of omission or failure to act (Wathne and Heide, 2000).

Actors who might behave opportunistically naturally include customers and suppliers, particularly when small-numbers bargaining increases the buyer's dependence on a particular supplier (Williamson, 1985). However, "opportunistic behaviour is often embedded in more complex relational settings than just dyads between the focal opportunist and the focal damaged party", including competitors and distributors (Schauwecker and Kühmann, 2007: 11).

Opportunism raises transaction costs when actors perceive a behavioural risk, and attempt to reduce it. Actors might respond to a fear of opportunism by incurring costs in attempting to prevent an unknown counterparty from behaving opportunistically by detailed drafting of contract terms (Williamson, 1975) or monitoring of performance (Zhou and Poppo, 2008), or by increased reliance on their prior knowledge of their counterparties (Douma and Schreuder, 2008). This fear might be increased if parties feel unable to judge the risk of opportunism or retaliate against it (*ibid.*).

The fear of opportunism may impact upon the willingness of actors to trade with others, if a perceived risk of impersonal exchange prevents trade with strangers and constrains the range of their trading relationships (North, 2003). Institutional protection can reduce this fear and facilitate a long-term transition to more efficient impersonal trading (North, 2003).

2.2.3 Specificity

Specificity describes an asset or investment that is particular to an individual relationship or transaction, or a resource that has been committed to a particular transaction such that it cannot be redeployed (Williamson, 1991). This can apply to sites or physical assets that are dedicated or tailored to a single customer-supplier relationship (Williamson, 1985), human assets such as dedicated staff (Poppo and Zenger, 2002) or intangibles such as knowledge transfer or client-specific training (Langlois and Robertson, 1995). Dedicated asset specificity describes a general-purpose physical asset acquired in support of a particular relationship, for example a hotel that is extended to accommodate the delegates attending a nearby conference centre (Lamminmaki, 2005).

Specificity causes the parties to it to become mutually dependent, reducing the appeal of alternative trading partners in comparison, and so may give one party power over the other (Rao, 2003). The power and dependency increase the risk of opportunistic behaviour, and an asset's value will be contingent on the continuity of the parties' relationship. Transaction costs are incurred in attempts to reduce the risk of dependency, through changes to governance structures including contract or internalisation (Williamson, 1985). Although these proposed linkages between degrees of specificity to predicted governance structures add predictive power to the theory, this precision is considered to narrow the applicability of the theory from the broader question of why firms exist, to a narrower question of vertical integration (Jones, 1997).

2.2.4 Transaction frequency

Transaction costs can effectively be reduced when transactions are repeated with the same customer or supplier, as the development and cost-amortisation of dedicated

structures (such as contract terms) become worthwhile, whereas one-off transactions will entail no particular changes to transaction governance (Williamson, 1985). This applies particularly to specific investments, which would benefit from specialised governance structures, but whose cost might only be recoverable under repeated transactions. Such repeated transactions offer the opportunity for the transacting parties to develop trust and so reduce transaction costs of opportunism, if they choose to cooperate in a repeated game rather than defect as anticipated by game theory (North, 1990). Frequency can be understood as the rate of the anticipated recurrence of similar transactions between two parties, and may also incorporate the volume of the recurring transactions (Colbert and Spicer, 1995).

2.2.5 Uncertainty

Uncertain environments confront organisations with exogenous changes that are beyond their own control, which might result from natural events or from the actions of other economic actors – respectively described as primary and secondary uncertainty (Williamson, 1985). Both of these forms are considered to be “innocent” or non-strategic, in contrast to the strategic intent of behavioural uncertainty or opportunism (*ibid.*). An extension of the concept of secondary uncertainty focuses on the actions of competitors amongst the economic actors, and suggests that their actions might be strategic or non-strategic (Sutcliffe and Zaheer, 1998) – which appears to merge secondary with behavioural uncertainty. The PEU2 measure of perceived environmental uncertainty (Werner et al., 1996) incorporates government policy, macroeconomic features, availability of inputs and infrastructure, and variability of demand in addition to competition. The environmental changes might vary in terms of frequency or amplitude (Wholey and Brittain, 1989), and unpredictability (Wholey and Brittain, 1989, Dess and Beard, 1984). Government policy can raise the level of uncertainty because “the possibility that policymakers

might be tempted to change laws, rules or regulations... creates uncertainty for the regulated” (Guler and Guillen, 2010: 191). The degree of uncertainty in a firm’s environment determines which contingencies can be anticipated, the costs of anticipation, and the range of possible responses.

Firms operating in an uncertain environment may need to adapt their strategies rapidly in response to changes (Krishnan et al., 2006), or draft detailed contracts to reduce the ex post transaction costs of enforcement (Barthélemy and Quélin, 2006). This latter approach expects that the saving on enforcement costs will be greater than the higher transaction costs of anticipating contingencies and drafting the detailed contract. A firm may also decide to discontinue trading with a particular partner depending on their perception of the partner’s stability in the context of uncertainty (Keister, 2001).

2.3 Expected responses to transaction costs

The transaction cost literature offers predictions as to how firms might respond to the causes of transaction costs, both in terms of the governance of individual transactions, and of their own resulting organisation structure. Where transaction costs are perceived to be very high, a firm is expected to reduce the number of market-mediated transactions by moving towards relational contracting, internalisation and unified governance structures (Williamson, 1975, Rao, 2003).

2.3.1 Transaction costs and the governance of individual transactions

Firms must decide whether to conduct individual transactions in the market (between firms), or to bring them within the firm, or some point in between. The choice will depend on the comparative efficiency of these options (Williamson, 1975). Transaction costs are kept to a minimum in the simple structure of classical

contracting, or arm's length market exchange (Williamson, 1985). This is appropriate when assets are non-specific, transactions are infrequent, neither party has market power over the other, and most contingencies are known – so straightforward terms can be specified *ex ante* and no adaptation or dispute is anticipated. “The lower the level of transaction costs *vis-à-vis* other costs, the greater the likelihood that resource allocation will take place within markets than firms” (Jones, 1997: 10).

When outcomes are less certain and contingencies harder to predict, a neoclassical or relational approach to the governance of repeated transactions may be preferred, in which the preservation of the evolving relationship between transacting parties is prioritised above the original contract (Williamson, 1985). This becomes appropriate when moderate asset specificity increases risk, but where parties do not attempt to draft formal contracts providing for contingencies, in order to minimise transaction costs. Instead, the parties respond to emergent contingencies with a less formalised bilateral approach, depending on mutual cooperation for the relationship to continue. In contrast to classical arrangements, the identities of and relationship between the transacting parties are of prime importance here. Although relational governance is more effective than classical contracts in uncertain environments where *ex post* renegotiation would be required, its dependence on informal sanctions makes it a less effective deterrent to opportunism (Carson et al., 2006).

A further option is for firms to reduce transaction costs by supplying some goods or services internally rather than procuring them from other firms, and by using single, incomplete contracts of employment rather than many separate contracts. This may be advantageous when complete contracts are not feasible, when there are or prospectively could be small numbers of potential suppliers, in situations where internalisation would remove the cost of information asymmetry by sharing knowledge, or where uncertainty could be reduced by convergence of both parties'

expectations (Williamson, 1975). In the latter two cases, asymmetric access to information can lead both to adverse selection when the party with information misleads the party without, and to moral hazard in the form of post-contractual opportunism (Rao, 2003). Drafting long-term, contingent claims contracts in an uncertain environment may cause prohibitively high transaction costs, in which case the transaction should be internalised instead, allowing the firm to adapt to emerging conditions rather than trying to anticipate them (Williamson, 1975).

This make-or-buy decision may, however, not be clear-cut due to the incompleteness of firms' information:

The decision whether to internalise or not is therefore not a nice matter of calculation, but a function of judgment and experience, which will include both an element of comparative costs and levels of risk involved (Jones, 1997: 18).

Even the decision to internalise a transaction does not avoid transaction costs altogether because the purchase of inputs will entail a share of the supplier's transaction costs, and internalisation cannot resolve a firm's internal transaction costs which include information search, coordination and motivation (Buckley and Carter, 1998). Finally, the reduction in transaction costs resulting from internalisation must be greater than the benefits foregone of trading in the open market – these being the customer's ability to switch suppliers, and the supplier's focus on core competencies and economies of scale (Milgrom and Roberts, 1992).

2.3.2 Transaction costs and organisation structures

The internalisation of markets for intermediate products or services leads to vertical integration (Buckley and Casson, 1976), which extends the boundaries of the firm and entails changes to its organisational structure. Transaction cost economics requires a comparative assessment of choices to understand firm-level decisions

regarding whether to contract out production or bring it in-house, the consideration of horizontal or vertical integration, and economies of scale or scope (Rao, 2003). Such an assessment asks whether firms have either pursued or considered internalising functions along or up the value chain, being internalised, or developing their relational arrangements into cooperative governance structures.

Where high asset specificity and frequency increase risk to the point that the transaction costs of comprehensive planning, monitoring and enforcement become prohibitive, a unified governance structure (with one party buying out the other) is an appropriate alternative (Williamson, 1985). This vertical integration has the effect of internalising all future transactions between the erstwhile customer and supplier, and incorporating both into an expanded, hierarchical governance structure. The cost of establishing the unified structure is offset against the notional reduction in the cost of repeated transactions that would otherwise have continued. As firms internalise more transactions, the scope of their productive activities expands:

When transaction costs between firms are high, firms will tend to trade within themselves. The boundaries of the firm will expand to internalise key markets for intermediate products, such as proprietary knowledge. The higher are arm's length transaction costs, the greater are the economies of internalisation, and the wider are the boundaries of the firm (Buckley and Casson, 1998: 18).

The boundaries may incorporate new areas that are closely related to the firm's core productive and distributive activities, or extend into more loosely related diversification (Dietrich, 1994). This eternal question of transaction cost economics is illustrated by Seabright (2004):

In the sea of decentralised market relationships, with no-one in overall charge, there are countless such [firms, or] islands of centralisation, planning and hierarchy... [the question is] to understand where the shoreline should be: where the islands need to end and the sea to begin (p153).

An alternative to the internalisation of other firms is the extension of relational governance to new organisational structures encompassing such firms. Alternative governance structures replace ownership with resource control through informal, cooperative mechanisms such as networks, alliances, licensing or franchises. They represent a compromise position between markets and internalised firms, which Seabright might perhaps have described as an inter-tidal zone between the sea of markets and the islands of firms.

The phenomenon of cooperative structures for the pooling of risks and resources has long been discussed, for example in the cases of peer-group associations (Williamson, 1975), or the post-war development of industrial districts in central Italy (Locke, 1996). They are collective, cooperative ways of organising production, sharing resources, risks, incomes and costs, achieving the economies of scale required for the acquisition and operation of physical assets, or the achievement of associational gains but without subordination. Contemporary equivalents would include professional partnerships such as those between lawyers or accountants (Douma and Schreuder, 2008), collaborative marketing clusters in tourist destinations (Moutinho et al., 1994), or networks. A network may be defined as a group of firms linked through transactions, or input and output relationships (Brown, 2002), and as such networks may be considered to be a type of organisation distinct from markets and hierarchies (Thorelli, 1986). They may be classified according to whether the relationships are vertical or horizontal, whether membership is open to all or restricted by invitation, whether there is transparency in identifying current members, and whether the network is intended to coordinate labour, capital or intermediate products (Buckley, 2004).

Cooperation can reduce the uncertainties of economic exchange, and so achieve lower transaction costs within a network (Rao, 2003). It is beneficial in reducing the

transaction costs of risk whilst also avoiding the resource requirements of internalisation (Thorelli, 1986, Buckley, 2004, Peters and Young, 2006). This is recommended particularly for start-up firms suffering a “poverty of resources and power”, where network structures present a “powerful resource-conserving alternative to internalisation” (Oviatt and McDougall, 2005: 33). Where interfirm relationships are cooperative rather than formal, relational norms moderate the costs both of initial contracting and of ex-post renegotiation when there is joint planning and information sharing (Artz and Brush, 2000). Poppo and Zenger (2002) agree that governance based on shared values and repeated transactions can lower transaction costs as compared to formal governance, in both economic (calculation of benefits of future exchanges within the relationship) and social (trust that has been developed during previous exchanges) terms. The norms and values referred to above indicate the relationship between transaction costs and institutions, which will be explored more fully in Chapter 4.

The transaction cost-inducing risks to which small firms are particularly vulnerable, and for which cooperation is an alternative to internalisation, are opportunism, uncertainty and bounded rationality (Nooteboom, 1993). In addition to the small or young firms described above, resource constraints will also be experienced by firms that are in decline or are uncertain of their survival (Martinez and Dacin, 1999). For such firms, these alternative organisational forms are also seen as a means of gaining market access and as a route to growth (Larson, 1992). Cooperation may emerge as the default response, in an environment where firms neither have the requisite resources to increase efficiency by internalising other firms, nor experience pressure to do so (Granovetter, 1985).

2.3.3 Responses to combined causes of transaction costs

In this section we move on from considering the individual causes of transaction costs, to the interactions between causes that increase the risk and thus the cost of a transaction. The behavioural, transactional and environmental characteristics of a transaction are collectively described by the term “atmosphere”, indicating that their “technically separable” effects are not necessarily “attitudinally separable” (Williamson, 1975: 37). Because of this difficulty of separation, Williamson recommends that the influence of these factors on transactions should be considered as a whole as well as individually, and so different responses might be expected when factors interact.

An individual’s bounded rationality limits his knowledge relative to other actors’, and constrains his ability to predict outcomes, often leading to incomplete contracts. If this information asymmetry is combined with an uncertain environment, under which a flexible strategy or detailed contracting might normally be expected, then the relative risks of market and firm transactions must be reassessed, and a move to internalisation considered (Williamson, 1985). The increased risk is also noted by Rao (2003), due to greater incompleteness of information.

When opportunism, which would cause parties to prefer a comprehensive contract, is combined with bounded rationality that would usually lead to an incomplete contract, “serious contractual difficulties” arise (Williamson, 1985: 66). Since the drafting of a complete contract is impossible, the parties become exposed to greater risks of opportunist behaviour (Luo, 2007). Milgrom and Roberts (1992) see a wish to protect one’s reputation as the key to removing incentives for opportunist behaviour under these conditions, echoing North’s (1990: 61) emphasis on “informal constraints”. In a similar vein, if opportunism is added to a relational contract arising

from uncertainty, effective monitoring will need to be supported by social sanctions (Carson et al., 2006).

Small-numbers tendering emerges where an initially broad pool of bidding firms contracts over time, due to first-mover advantages or increasing asset specificity – “what was a large numbers bidding condition at the outset is effectively transformed into one of bilateral supply thereafter” (Williamson, 1985: 61). This is described as a fundamental transformation, locking the buyer in to an emerging monopoly. The risk here is that the supplier’s long-term interest in maintaining the relationship might be subsumed by a shorter-term opportunity to maximise his present profits (Williamson, 1985). In this case, damage to an opportunist supplier’s reputation is not an effective deterrent, as the buyer has no alternative suppliers to choose from (Douma and Schreuder, 2008). Since opportunism and uncertainty in a small-numbers situation will require regular adaptation by both parties, this is expected to lead to relational governance to promote a longer-term perspective (Artz and Brush, 2000), or to internalisation in the case of frequent transactions (Williamson, 1985).

2.4 Contextual limitations and critiques of transaction cost theory

Despite the strengths of transaction cost theory in identifying sources of friction in exchange and proposing resolutions, criticisms of it include making assumptions concerning behaviour and the strength of formal institutions that might reduce the degree to which it can apply in non-Western or emerging market research contexts. Some consideration of these limitations is necessary before the case can be made for an exploratory study in China, whose main aim will be to try out the theory in a context that is heavily influenced by institutions. A fuller theoretical consideration of the role of formal and informal institutions will be presented in Chapter 4.

2.4.1 The applicability of transaction cost theory in other contexts

The view that transaction costs of information asymmetry and opportunism will uniformly lead to the transfer of transactions from the market into the hierarchy has been strongly challenged. For example, it is contradicted by the reverse flow to the market from formerly integrated firms in the Japanese textile industry (Dore, 1983), which is attributed to Japan's Confucian tradition that emphasises stable, long-term trading relationships in contrast to the Western emphasis on self-interest or profit maximisation, which Dore dates back to Adam Smith (1776), and considers Williamson to take for granted. A similar reversal from vertically integrated production to a network of smaller, more specialised firms has been documented in the Biellese region of northern Italy, as a response to intensifying competition from emerging markets (Locke, 1996). This study takes these exceptions as an encouragement to apply transaction cost theory in China, a context that shares Japan's Confucian tradition and so might also share its low incidence of opportunism. On the other hand, the increasingly aggressive competition following the economic reforms of the 1980s (Li, 2008) might make stable, long-term relationships and the formation of networks more of an aspiration, and opportunists and transaction costs the current reality.

The assumption of opportunism has further been criticised for overstating the risks of exchange, and hence the rationale for internalisation (Hill, 1990). In this view, the market is expected to remove habitual opportunists through two mechanisms. The first mechanism is based on a repeated-game prisoner's dilemma and results in the evolutionary selection of cooperative actors, as their avoidance of opportunist behaviour reduces transaction costs and so maximises the potential returns of a long-term relationship. Hill acknowledges that this assumes effective communication of changes in reputation, the absence of which would entail the transaction costs of information search, but his assumed pre-existence of a few cooperative actors goes

unchallenged. He also takes for granted some effective legal protection of cooperative actors from opportunists, an omission addressed in the observation that the market creates a need for protection from opportunism but does not actually provide that protection (Ghoshal and Moran, 1996). The second mechanism removes opportunists from the market through bankruptcy or takeover. Hill's own implicit assumption that sound formal institutions will be present to conduct bankruptcy proceedings and finance takeovers, may confine the applicability of his work to contexts where these are available. The more generic expectation of detailed contracting as a response to transaction costs (Williamson, 1975, Barthélemy and Quélin, 2006) also holds an implicit assumption, that an appropriate legal framework will be present; North (1990) challenges this with his observation that successful contract enforcement is dependent upon institutions to constrain self-interested behaviour. This research will therefore seek out a Chinese research context that is similarly subject to transaction costs but does not offer strong legal protection or financial institutions (Zhou and Poppo, 2008), to find out whether opportunists are still excluded from the market as Hill expects and contracting is possible, or whether actors develop an alternative response to transaction costs.

2.4.2 Studies applying transaction cost theory in the research context

Earlier studies making empirical applications of transaction cost theory have been criticised for a tendency to “understate the significance of contextual factors” (Tseng and Kuo, 2008: 1), which this study aims to avoid in both its attention to the context-specific literature and in its method. Here we consider briefly the causes of and responses to transaction costs that have previously been found in the context of this study – being China, specifically the tourism sector and small firms operating in it. The aim is to explore the extent to which we may expect the theory to be appropriate

to the setting, and the setting to offer an interesting context within which to study the theory.

2.4.2.1 Causes of transaction costs in the research context

The transaction costs caused by behavioural and environmental factors have been found to increase in the presence of weak legal institutions. Emerging markets may experience increased risks of opportunism, as weak legal institutions and enforcement invite rent-seeking behaviour (Rao, 2003), which in turn may have a negative impact on national economic performance (Colombatto and Macey, 1999, Rao, 2003). Early work on transaction costs in China focused on legal institutions for agriculture, specifically contracts (Cheung, 1969) and land tenancy (Cheung, 1974). In present-day China, the availability and cost of information varies by geographic region and by industrial sector, which is attributed to the different stages of economic development and the “different levels of governmental interference [that] cause industrial differences in information accountability” (Luo, 2007: 43). Institutional uncertainty causes high transaction costs (Luo, 1997), and “both transaction cost and information processing complexity increase with industry structural instability, information unverifiability, and law unenforceability” (Luo, 2007: 40). This latter point encompasses the factors of uncertainty, bounded rationality and rule of law, and the risks of these factors for firms operating in China have been found to increase with distance from the coastal economic centres (He, 2002).

The development of information asymmetries between Chinese firms has been traced back to the period of economic transition and the accompanying high risk of opportunism, which made potential trading partners reluctant to share information and also hindered the development of trust between them (Keister, 2001). Opportunism has been found to be a greater risk in transactions taking place between groups than within groups, as a result of collectivist cultural conditioning (Chen et

al., 2002). Internalising knowledge, especially unpatentable knowledge, has long been expected to substantially reduce the risks of both opportunism and information asymmetry (Buckley and Casson, 1976). Calls for more explanation as to when this would be most efficient (Buckley, 1983) were answered with reference to the high transaction costs of repeated international transfer of tacit knowledge requiring two-way communication, especially where the knowledge needed to be protected from disclosure to competitors and where institutions for legal redress were weak (Teece, 1983). We therefore expect transaction costs to be particularly high where the Chinese context combines asymmetry, opportunism, and weak protection of intellectual property rights (Massey, 2006).

In the tourism sector, transaction cost theory is recommended for the analysis of organisational development in the supply chain, and the internalisation pressures that firms face at each stage in the chain (Buckley, 1987). However, Tremblay (1998) considers the approaches of Williamson (1985) in general, and of Buckley (1987) in the context of tourism, to relate simply to short-term efficiency gains made through information asymmetry. He counters that the theory “fails to provide a valid justification for long-run strategic decisions concerning the integration, diversification, and other substantive changes in the boundaries of the firm in the tourism market”, such as changes driven by the “rapidly changing technological environment” confronting the tourism sector (p844). The term “dynamic transaction costs” is used to describe the specific training and coordination of local suppliers that is needed to keep their capabilities up to date with technical change (Langlois and Robertson, 1995: 54). The question of technological change may, however, be of secondary importance in a body of theory that has otherwise been criticised as static (see section 2.4.3), and in the research context of a developing region where firms might give higher priority to short-term savings than to technology or long-term strategy (Martinez and Dacin, 1999), and where the transfer between tour operators

and local accommodation providers may be more likely to concern training in service standards than advanced technology.

Nooteboom (1993) observes that small firms incur higher transaction costs than large firms, when the costs are related to bounded rationality, uncertainty and opportunism. Their limited resources and low trading volumes impact their ability to conduct information search and monitoring, and their narrower range of suppliers hinders the spreading of risk against opportunism. In contrast, Granovetter (1985) expects small firms' networks of social relations to protect them from the opportunism that would otherwise push them towards integration. This common emphasis on behavioural and environmental causes, rather than transaction characteristics, is reiterated by McGee and Sawyerr (2003). Under conditions of uncertainty, they expect small firms to suffer higher costs of information search, as their limited internal resources cause them to depend on networks and external sources of information.

In conclusion, the small, Chinese tourism firms researched in this study are expected to experience transaction costs, with an emphasis on those caused by bounded rationality, uncertainty and opportunism. The level of these costs may also be increased by weak legal institutions. The next section will consider whether they are likely to respond to the transaction costs in the same way as is anticipated by the literature.

2.4.2.2 Responses to transaction costs in the research context

Studies applying transaction cost theory to the Chinese research context find more evidence of cooperation than the other expected responses, and their authors explain this with reference to cultural factors and formal institutions.

A survey of Chinese manufacturers finds that informal, relational ties are a more common response than formal contracts to the transaction costs of uncertainty, opportunism and specificity (Zhou et al., 2008). China's weak legal system is often cited as a reason why firms do not pursue detailed contracts in response to transaction costs. Firms are unlikely to use contracts to safeguard specific investments against opportunism, as they cannot be confident of an equitable division of assets by the courts in the event of contract termination (Zhou and Poppo, 2008). In addition to this weakness, the soundness of legal systems and law enforcement varies across China's regions – generally being weaker in less developed areas – and can be unpredictable due to political influence (Luo, 2007). Mutual hostage-taking can help to reduce the risks of opportunism in cases where neither contracts nor trust can be depended upon to govern exchange (Choi et al., 1999).

The preference for relational ties over contracts is attributed to the strength of shared norms between customer and supplier, although in future the balance may tip towards contracting as China's institutional reforms proceed (Zhou and Poppo, 2008) – which Peng (2003) anticipates during economic and institutional transition. Zhang and Keh (2010) associate private firms' dependence on relational ties both with an early stage of market transition, and with an early stage in the firms' development – proposing that as the institutions and the firms develop, their emphasis will move from relational ties to contracting. An earlier survey also found that levels of management networking increase with levels of uncertainty, and also with increased regulation and competition (Luo, 2003). A study of overseas Chinese firms found that networks could be effective in shielding their members from the high transaction costs caused by corruption (Buckley, 2004).

Opposing views are put forward to explain why some Chinese firms do not carry out their intention to internalise. On the one hand, they may wish to internalise, but be prevented from doing so by economic regulations (Peng and Heath, 1996); on the other hand, they may fear the loss of face that would result if the proposed acquisition were to fail (Luo, 1997). In both cases, exchange and growth proceed via informal networks rather than internalisation.

As regards responses by small firms, Nooteboom (1993) considers cooperation, networks or “quasi-integration” in industrial districts to be practical alternatives to market-based transactions. Given their constraint of scale he does not consider internalisation as an option, in contrast to Buckley and Casson (2009), who contend that the principle of internalisation can explain the changing boundaries of organisations of all sizes, down to “ ‘do it yourself’ production” by individual households (p1566).

The literature concerning the responses of tourism firms to transaction costs focuses mainly on vertical integration by large firms (see, for example, Buckley, 1987), although the Eclectic Paradigm has been adapted to reflect the changing patterns of ownership and internalisation by multinational enterprises in the international hotel sector (Dunning and McQueen, 1981). Ownership of intangible assets such as brands supersedes the potentially risky ownership of overseas hotel buildings, and internalisation is interpreted as the degree of control exercised through franchises or service agreements. The linkages that might constitute cooperative structures between firms in the tourism sector may run backwards through the value-chain, including direct employment in tourist services, indirect services to tourism providers, and spillovers into sectors such as food production and light manufacturing, or forwards to agents selling services direct to tourists. The types of cooperation in the tourist sector range from informal links within the trade, to

professional or public bodies either in the same sub-sector or at a common destination (Holloway, 2001).

In conclusion, although the causes of transaction costs are expected to affect the firms in this study's research context, this literature suggests that these firms' responses might tend more towards forming cooperative relationships than to either contracts or internalisation.

2.4.3 Further critiques of transaction cost theory

A common criticism of transaction cost theory is that, although it can offer an economic accounting for actions (Martinez and Dacin, 1999), its assumption that actors' aims are to minimise transaction costs (Dietrich, 1994) causes it to fail to consider the importance of social relations and trust (Douma and Schreuder, 2008). This has been succinctly described as an under-socialised explanation of economic action (Granovetter, 1985), which this study attempts to address by its consideration of informal institutions (in Chapter 4) as social influences on economic behaviour, and the selection of a research site in which social relations appear to be very important to business.

Another criticism is that transaction cost theory takes a static viewpoint from which to explain the behaviour of firms, which is in fact dynamic (Dietrich, 1994). This has been interpreted to mean that the very survival of firms demonstrates that they have succeeded in reducing their transaction costs, and so any sample for transaction cost research is self-selecting (Buckley and Chapman, 1998d). This idea of self-selection would also imply that firms have reached a stable status quo, without ongoing competition between firms (Douma and Schreuder, 2008). If the theory is in fact static, then this implies a close correspondence with the cross-sectional nature of the data collection in this study. However, the collected data also indicate that high

transaction costs might not have the effect of introducing a survivorship bias, so much as hindering the performance and development of the affected firms. The data also suggest that the inception, maturation and decline of firms, and the competition between them, is ongoing and the situation is dynamic rather than stable.

Concerning the applicability of transaction cost theory to tourism, Tremblay (1998) pursues Dietrich's (1994) point on dynamism. In Tremblay's view, Williamson (1985) assumes a stable level of technology that does not affect decisions, but he contends that the pace of technological change is very pertinent to decisions regarding internalisation and firms' boundaries in tourism. Tremblay in turn has assumed the tourism sector to be uniformly operated by well-resourced multinationals able to invest in changing information and communications technologies.

A final criticism concerns the danger of transaction costs being used to explain almost any outcome (Williamson, 1985). The author's response to this will be to present a clear research design in Chapter 5, to allow the reader to judge whether the theory has been applied appropriately to fulfil its potential:

Transaction cost economics, despite its faults, remains the best means of coping with the complexities of international business (Buckley, 1998: xvii).

During the course of this thesis a series of four flowcharts will be presented. This is intended to illustrate the progression in the author's conceptualisation of firms' responses to transaction costs. It begins with the initial review of transaction cost theory in the current chapter, via modifications made following the exploratory study described in Chapter 3, through the patterns observed in the empirical findings in Chapter 8, to the recommendations made in Chapter 9.

The literature that has been reviewed up to this point identifies causes of transaction costs including bounded rationality, opportunism, asset specificity, transaction frequency and uncertainty. In response to high transaction costs, and subject to institutional restrictions, firms are expected to move from arm's length market exchange to relational exchange, to internalise intermediate markets or to establish cooperative governance structures. This anticipated pattern is illustrated in Figure 4 below, and was explored in the research context during the exploratory study, which is the subject of the next chapter.

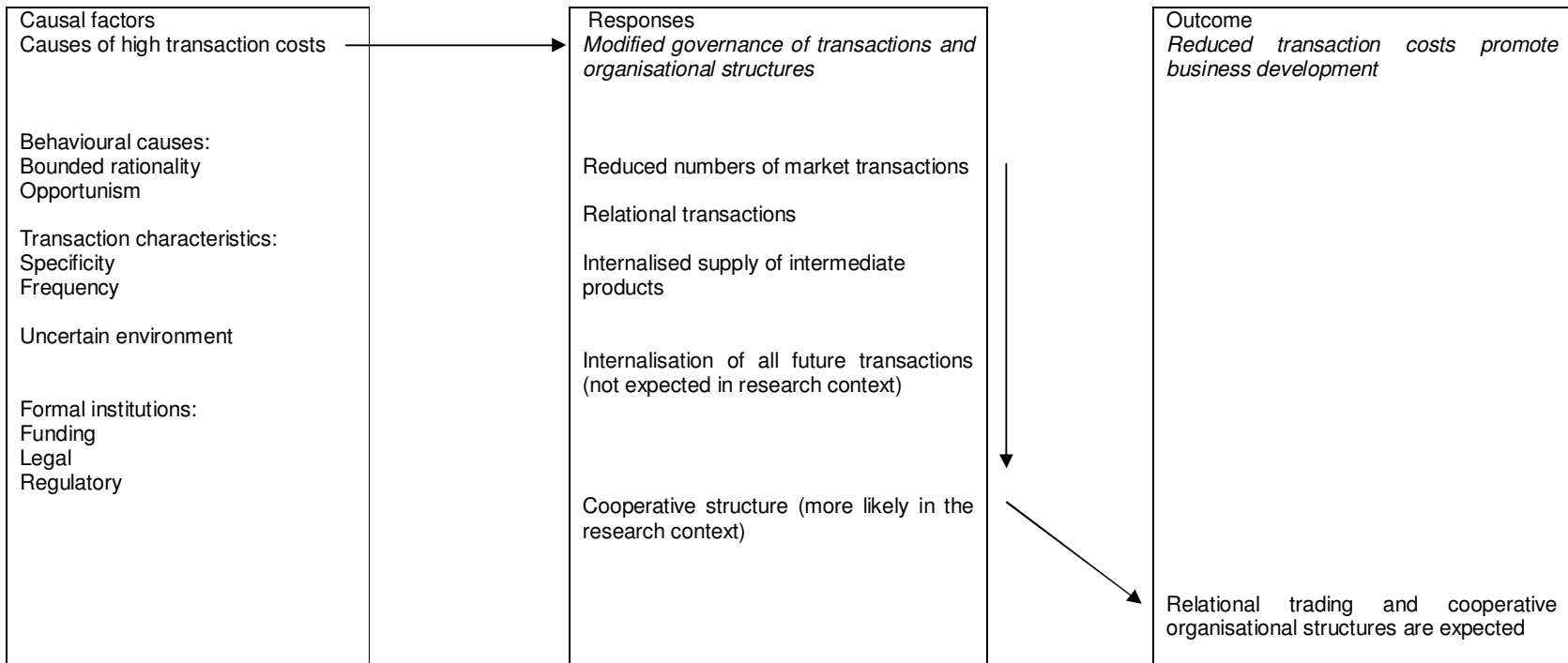


Figure 4 Flowchart 1 – Causes of and anticipated responses to high transaction costs

(Source: author)

CHAPTER 3 EXPLORATORY STUDY

This chapter describes the aim, method and findings of the exploratory study undertaken by the author in the Tiger Leaping Gorge in 2007. It demonstrates the pivotal role of the exploratory study in the subsequent formation of the research questions, and in the identification of the first of two observed gaps in the literature.

3.1 Rationale

The exploratory study was considered to be important in order to assess the feasibility of the proposed study, as a certain degree of fit between theory and site would be required in order to yield interesting findings, but too close a fit would risk failing to make a new contribution. Chapter 1 justified the selection of the Tiger Leaping Gorge as the research site and explained why, based on her prior knowledge of the site, the author expected that it would offer an appropriate context in which to explore the causes of transaction costs and firms' responses to them. In particular, the transaction cost literature reviewed in Chapter 2 had suggested that behavioural and environmental causes, and cooperative organisation structures, might well be in evidence. However, the author still considered it prudent to conduct a small-scale exploration in advance of the principal data collection exercise, rather than assuming that the theory would prove to be substantially applicable.

3.2 Method

A largely inductive approach was taken to the exploration of behaviour related to causes of and responses to transaction costs in the research site. The modifications to pure induction recommended by Lindsay (2004) allow for both a Straussian preparatory review of previous research prior to the author's own theory generation (Easterby-Smith et al., 2002), and familiarisation with the research setting to increase

the relevance of the data and the economy with which they are collected (Miles and Huberman, 1994). The data collection was conducted in the form of an ethnographic reconnaissance (Wolcott, 1999: 207), which is intended as an orientation period before the development of a complete research strategy and so does not call for formal interview schedules or sampling of participants. The openness of this approach allows for the emergence of further issues that are of current concern to the study's participants (Kirk and Miller, 1986, Easterby-Smith et al., 2002). Such emergent issues can in turn feed into the formation or modification of research questions at an early stage, as is characteristic of an ethnographic approach (Robson, 2002).

An investigation into the participating firms' responses to transaction costs would naturally address their trading relationships with customers and suppliers. Since relationships should ideally be researched from both sides (Coviello and Jones, 2004, Hansen, 2008, Yang et al., 2006), the author first concentrated on international tour operators, as clients of the firms who were the focal participants in the exploratory study, who could offer an informed yet detached view of the commercial environment in which the participant firms operate. Tour operators were selected in preference to individual guests who would be unlikely to maintain relationships with the participants, and in preference to local suppliers with whom the researcher would have no ready opportunities for securing access. This approach would also help to avoid the pitfall of locally-focused business research that fails to engage with an international perspective (Malmberg, 2003). This preliminary contact with tour operators was of further benefit in offering the author an initial steer towards potential participants who the tour operators identified as their partners, prior to encountering other participants during the course of the exploratory study.

3.3 Discussion of findings

This section describes the findings of the two stages of the exploratory study, the first with international tour operators and the second in the field in China, and discusses the issues that emerged during the course of the exploratory study.

3.3.1 International tour operators

International tour operators offering itineraries in the Tiger Leaping Gorge were identified from guidebooks, websites and brochures, and those with responsible tourism policies that highlighted local service provision were selected, as the author interpreted this as an indication of an emphasis on long-term relationships with local service providers. See, for example, the websites of Exodus (2007), Imaginative Traveller (2009), Intrepid (2008) and World Expeditions (2009). The author conducted preliminary interviews with management representatives of two of these tour operators (hereafter referred to as TO1 and TO2) in London, which is the global headquarters of TO1 and the European headquarters of TO2.

These interviews revealed a marked distinction between the degree of contact between the tour operators and local firms, and the considerations that drive it. As a response to the perceived difficulty of the regulatory environment, TO1 has subcontracted its entire China operation to a Chinese agent based in Beijing. This agent employs its own tour guides, who are Beijing residents but accompany groups throughout China, and handles domestic travel and accommodation bookings. The agent further subcontracts local accommodation bookings to its own provincial agents; it occupies the top of a hierarchical structure in China, and reports upward to TO1 in London. There is informal contact between the tour guides and local families who host “farm visits”, but these appear to be ad hoc and unannounced rather than drawing on a reciprocal relationship.

None of these agency relationships is exclusive, and the agents in Beijing and the provinces have no specific investment in their upward relationships apart from staff briefing in company principles such as responsible tourism. TO1 has a formal, contractual, arm's length relationship with the agent, and as it values the agent's position as a buffer between TO1 and the difficult environment, there is no inclination to internalise. The agent described this as a good working relationship of ten years' standing, in which both parties respect the efforts made by the other. TO1 has no contact with tourist service providers in the local destinations, and owns no fixed assets in China.

In contrast, TO2 has its own staff in China, having experienced difficulty in finding reliable local operators. It has an in-country ground manager and employs dedicated Chinese or foreign guides, who are described as having detailed local knowledge and good relationships with the accommodation providers, and who report site-specific conditions back to the ground manager. They report the deliberate cultivation of long-term relationships with these accommodation providers, who they then expect to meet emergent needs rather than having to rely on formalised booking procedures. The London manager explained that the prioritisation of TO2's bookings by local providers confirms that they value their good relationship with TO2, and this suggested to the author that there is transaction frequency and a degree of specificity in the informal relationship. The manager felt that internalisation of accommodation would be an option in cities where multiple tours start and finish, but not locally as TO2 aims to offer cultural immersion and its clients demand a local flavour in their trips.

One of TO2's tour leaders described his long-standing friendships with three family-run guesthouses in the research site, to whom he takes groups on a weekly basis. Their relationships are informal and social rather than business-like, bookings are

made by telephone and they always find room for his groups. TO2 has not required any specific investment or provision by the guesthouses, but can fill the smallest one to capacity. TO2's ground manager confirmed that his firm values its relationship with guesthouse proprietors highly, and indicated a long-term orientation in referring to an annual exercise of agreeing prices with the guesthouses. He expects his tour leaders to maintain these relationships, which would only be terminated if the guesthouses were to fail repeatedly to meet TO2's needs or standards. A two-way relationship was implied by the ground manager's statement that the guesthouses expect fair treatment and sufficient notice from TO2, and that "we can provide support and help to them if they need it".

The further exploration in the field site of specificity, frequency and cooperation therefore had some grounding in TO2's reports as well as the theory referred to in Chapter 2. However, this was not strongly corroborated by the guesthouse proprietors, who were the counterparties to these reportedly close relationships, and other causes of transaction costs appeared to be more significant.

3.3.2 Field study

An aim of the exploratory field study was to explore the relevance of transaction cost theory and the local firms' view of their relationships with the international tour operators. It incorporated interviews with five firms in the research site – including the firms mentioned by TO2 – and less detailed conversations with a further two. There were also interviews with TO2's contacts in the provincial capital, Kunming, and relevant tourist authorities in Kunming.

The author's discussions with TO2 had led her to anticipate the firms' descriptions of their relationships with the international tour operators and guesthouses to include knowledge of the tour operators and their needs, a commitment to meeting these

needs, and a long-term orientation, which would correspond to specificity, frequency and cooperation or a valued relationship. Three of the guesthouses received tour groups with sufficient frequency that they were accustomed to taking bookings by telephone, but there was no specificity in the provision of services or accommodation. All appeared to react to the tour operators' booking requests, rather than to actively attempt to manage a relationship, or to handle the client firm differently to other customers. Only two of these guesthouses could name the firms that regularly sent them groups of clients. It therefore appeared as though the author's expectations had been raised by TO2's description of deep and mutual relationships, but that the local firms considered them to be more arm's length and unexceptional.

Discussions about how the participants interacted with other local firms were used to explore whether any of the behavioural causes of transaction costs were present. Cross-marketing by firms that were not in direct competition with each other was observed only in towns and cities outside the actual research site. The author interpreted this as a possible indicator of greater bounded rationality or fear of opportunism in the rural areas, or a lack of trust in remote partners who could not easily be monitored (Zhou and Poppo, 2008). Staff at most guesthouses within the research site were willing to refer guests on, if always to a guesthouse far enough away not to be a direct competitor. One proprietor explained that her guesthouse was too newly-established to have acquired this local knowledge – one and a half years after opening – suggesting that overcoming bounded rationality would be a long-term exercise, that would hinder her ability to cooperate or to inform herself about her competitors. Reports of behaviour between competing guesthouses, that struck the author as connoting opportunism, included a “willingness to lie, if only by omission”. Local taxi drivers were also said to have misinformed tourists during a

period of great danger from landslides in the month before the exploratory study, when a premium was charged for a risk of which the passengers were unaware.

A very high degree of uncertainty in the operating environment was evident, with most participants being very concerned at rumours that the national government intended to dam the gorge for a hydropower scheme. This would require all the firms to relocate and so lose their businesses, at an unspecified time in the future. Two participants described the uncertainty of the government's plans, and the impossibility of expressing opposition. One mimed handcuffing the author, and the other aimed an imaginary rifle whilst repeating the word "soldier" in both Chinese and English to be sure that the author had understood his fear. They both said that local life had been severely disrupted, and they could not plan for the future. One participant, however, had lodged a formal protest with the national government's Development and Reform Committee. Another participant claimed his business was being damaged by environmental destruction resulting from tungsten mining, diminishing the attraction of the gorge to tourists and reducing the scope of services he could offer. His formerly vibrant mountain-guiding service was virtually defunct by the time of the exploratory study in 2007.

The ways in which the participant firms might respond to high transaction costs, including internalisation, relational trading and cooperation, were explored throughout the tourism value chain (Holloway, 2001), in both the vertical relationships between guesthouses and tour operators or suppliers, and in the horizontal relationships among the guesthouses. The firms reported that they had limited access to funds to take over any other supplier or competitor firms. The international tour operators are in turn constrained by the bar on wholly-foreign ownership in the Chinese hotel sector (World Bank, 2004), and are deterred from acquiring stakes in guesthouses by the perceived property risk. Internalisation of

guesthouses would also jar with the tour operators' stated commitment to the support of local businesses through their responsible tourism policies.

The interviews with TO2 had suggested that it would be reasonable for the author to expect to find cooperation between tour operators and guesthouses in the field. The closest relationship observed in the field was between TO2 and the smallest guesthouse. This proprietor explained that her key problem was market access: potential guests had no prior knowledge of the guesthouse as it was not mentioned in the guidebooks, and the language barrier hindered her attempts to catch passing trade. Working with TO2 offered a solution to both problems, but this suggested to the author a degree of dependency on the tour operator as has been observed in small European tourist accommodation enterprises (Bastakis et al., 2004), rather than reciprocal cooperation. In general, the local firms' immediate concerns were focused more on growth than on long-term strategies or ethics policies (Churchill and Lewis, 1983), and this was reflected in a pragmatic approach to relationships with tour operators.

Supplier relations appeared to be confined to a small number of personal relationships. Transactions were regular in cases where each party could trust the other, and the seller understood the buyer's requirements. There was, however, little suggestion that this embodied the cooperative alternatives to internalisation, more than the simple direction of business towards a few favoured individuals. One participant described these informal relations as "favours to be repaid", rather than either cooperation or arm's length transactions.

The exploratory study sought evidence in the research site of commitment to relationships and associated specificity or frequency, but it found more limited support for these ideas than for the remaining transaction cost drivers of bounded rationality, opportunism and uncertainty. Although frequent visits by international

tour operators (including TO2) alleviated the resource constraints of one of these firms, and three more firms regularly hosted tour groups, the operating procedures of all the firms interviewed reflected less the expected approaches of cooperation or internalisation, than an attitude of self-reliance in which the firms only traded outside for goods or services that were not available internally (this is discussed further in section 3.3.3).

This self-reliance was further in evidence in the author's interviews with business contacts of TO2, which extended beyond the intended research site. In Kunming the author spoke with three large, Chinese tourist service providers. The observed inclination to be a self-reliant generalist, rather than a specialist within a network of providers, was evident even in a 200-room hotel. Owned by the Yunnan Provincial Government Tourist Board, this hotel kept all activities in-house including the laundry service and even the ownership of the bicycles rented out to guests. A state-owned travel agency, also under the authority of the provincial tourist board, was the only enterprise to describe a partnership with an overseas tour operator – suggesting that this is only possible for large firms with state backing. It also had formal contracts with suppliers and agents in local destinations, indicating a very different scope of activity to the other interviewees.

Exploratory interviews were also conducted in Dali, an ancient walled city that is visited on TO2's Yunnan itineraries, with three local service providers who cater to inbound tourists. Here the businesses were independent and competitive, they did not cooperate with other local firms, nor did they report significant trade volumes or relationships with foreign tour operators. One interviewee was a guesthouse proprietor who offered homestay visits with farming families; this seemed neither to be a commercial relationship nor reciprocal cooperation, as the visitors appeared to be imposed on the families unannounced. This interviewee saw himself as the sole

source of cash income for the host villagers, which indicated that the risk of dependency was present in domestic as well as international relationships.

3.3.3 Emergent issues

Although the interviews described above suggested that the theory of transaction costs could explain the behaviour of the firms to a limited extent – as cautioned by Luo (1997), the local Chinese context cannot always be fully accounted for by Western theory – they did, however, uncover matters of urgent concern to the interviewees that the author had not anticipated. These concerns offered alternative perspectives that served both to steer the further study in a direction that was more meaningful to the participants (Kirk and Miller, 1986), and also clearly demonstrated that the research site was a high transaction cost environment.

The procurement behaviour of rural guesthouses with comparable road access was very variable. Whilst most offered home-grown food, one described the inconvenience of buying it in from the nearest town. This suggested to the author that the latter firm might not be strongly integrated into local kinship networks (Peng, 2004) that could otherwise have provided farming labour, and so alternative informal structures took on increased emphasis in the ongoing research. Kinship or social networks were also important to a participant in the research site and two in Dali, and one Dali interviewee distinguished between social networks and political *guanxi*, with each serving distinct purposes to his business.

Formal institutions limited the options open to the firms. Regulatory constraints on strategy are experienced both by hotels where the provincial tourist board has a degree of ownership and managerial control (this was reported independently by the state-owned travel agent, and by a Chinese academic researching the impact on Dali and Lijiang of increased transport infrastructure), and by tour operators who are

required to hire local guides at every site visited (confirmed by both local and foreign operators). Formal sources of finance were reported to be unavailable to the firms in the research site, so any investment was funded from such profits as were retained and the need for self-reliance was reinforced. Property rights were widely considered to be uncertain. The risk of expropriation could not be avoided by the Chinese interviewees, but the foreign-owned firms refrained from investing in fixed assets altogether. The national and local governments were not thought to be accountable to the locals, whose livelihoods were directly impacted by government sale of land for mining operations.

The firms demonstrated little specialisation, engaging instead in a wide range of productive activities. In the light of subsequent events, namely the earthquakes and political unrest of Spring 2008, the author considered that the high risk-level of the environment might demand diversification rather than specialisation in business. The responses to risk varied, though, and so merited further investigation. For example, most guesthouses were run alongside continuing farming activity, but one guesthouse proprietor no longer farmed. Most proprietors felt that their businesses were threatened by the mining operations, but one was actively involved. This raised questions as to whether he was responding to a decline in tourism or contributing to it, and whether there was a mechanism for environmental protection or compensation for externalities.

3.4 Conclusions drawn from the exploratory study

In summary, the exploratory study has suggested that transactions were impeded between the participating firms and other firms. If their resulting insularity persists, they are unlikely to develop further and bring economic benefit to a wider group than the family members and others currently employed. The difficulties that the participants described correspond to some of the causes of transaction costs, and also

to problems of weak institutions, both formal and informal. Yet the exploratory study did not find the expected structures of internalisation or cooperation, despite the presence of transaction costs. In fact, the firms' response appeared to be an attempt to reduce transaction costs by reducing the number of transactions they conducted, resulting in self-reliance and their isolation from trading relationships.

Such a disparity between a researcher's "schema-guided expectations" and their findings is referred to as a "breakdown", which serves to highlight problems meriting further attention (Agar, 1986: 21). This is then addressed by modifying the schema of understanding and returning to the field or comparing it to the findings again, in an iterative cycle until the breakdown is resolved. As the breakdown occurred when self-reliant isolation emerged as a more common response than cooperation or internalisation, this is explored in the next section as a possible gap in the literature. The emergent weakness of institutions is considered to be a possible reason why firms might respond through isolation. The second section of the literature review, presented in Chapter 4, therefore considers the importance of institutions in relation to transaction costs, and makes the proposition that institutions might play a mediating role between transaction costs and firms' responses to them. Isolation and institutional theory are then used to modify the schema of understanding. If the aim of transaction cost economics is simply to minimise transaction costs (Dietrich, 1994), then the firms' cost minimisation by reduced trading or isolation should be explored, theoretically and empirically, as another possible response to these costs.

3.5 Isolation as a response to high transaction costs

We now revisit the literature in search of alternative responses by firms to perceived transaction costs, which could better explain the tendency towards self-reliance and consequent isolation of firms observed in the exploratory study. We seek circumstances under which firms might reduce the number of transactions they carry

out or the number of relationships they maintain other than through internalisation, causing them to become isolated from – rather than integrated into – a network of trading relationships. The discussion is centred on weak market institutions and informal constraints, and the hindrances that these pose to specialisation, before isolation is identified as a sensitising concept to be adopted in the continuation of this study.

3.5.1 Market institutions and specialisation

Under circumstances where uncertainty combines with long timescales to make transaction costs prohibitively high, such that classical contracts become impossible to draft completely: “One [alternative] would be to forgo such transactions altogether” (Williamson, 1985: 70). The other alternatives that Williamson proposes are internalisation or neoclassical contracting with third-party arbitration, all of which would aim to preserve the continuity of the trading relationship beyond the lifetime of the transaction in question.

The avoidance of individual transactions is drawn into a consideration of its impact on the scope of the firm’s ongoing activities by North (1990) who, like Adam Smith (1776), considers exchange to be the foundation of specialisation. The causal chain is further extended by the view that trust is a prerequisite for exchange, that enables specialisation, which is the basis of wealth (de Soto, 2006). If transaction costs are high and exchange transactions are limited, firms will be unable to specialise, so isolation and non-specialisation are both consequences of high transaction costs. This view is supported by Arora et al. (1996), who expect specialisation to result from low transaction costs that enable firms to trade in intermediate goods. Non-specialisation is explained as “a form of insurance when the costs and uncertainties of transacting are high” (North, 1990: 34), which offers multiple income sources to sustain uncertain livelihoods (Ellis and Biggs, 2001). This is because when transaction costs

and uncertainty are high, firms may reduce the costs of such transactions by avoiding them; in consequence, firms which are isolated rather than actively trading cannot specialise. North concludes that such firms experience a trade-off between the lower transaction costs of limited personal exchange, and the higher production costs entailed by limited specialisation and division of labour. The opportunity is missed to specialise, and so to capitalise on a competitive advantage, and the firm becomes isolated in its self-reliance. The institutional support that would be necessary for a transition from personal to impersonal exchange is discussed in Chapter 4.

The question of division of labour is pursued in the context of economic development, where market institutions exist but are not trusted by the firms who would otherwise use them: “They prefer to remain self-sufficient rather than participate in a division of labour because they do not trust the market process” (Buckley and Casson, 1998: 17). In this case, firms fear that there is no institutional protection from the risk of opportunists in market transactions and so they avoid them, relying instead on their own subsistence production. Firms may also continue in-house production to avoid a perceived risk of opportunist suppliers withholding inputs, in addition to changes in the costs of purchasing or of production (Lyons, 1995). This presents isolation as the chosen strategy of the decision-maker, to protect his firm from risk and to reduce its transaction costs. In developing countries, isolation may also be an outcome that is imposed on the firm rather than chosen by it, as a result of insuperable barriers to participation in markets or the formal economy. These might include the costs of company registration, weak property rights that make investment unacceptably risky, or lack of title to property that prevents firms from borrowing to invest through their inability to post collateral (Cleaver, 2007). Ineffective or absent institutional support is also seen as the cause of low market participation by the poor (Mair and Marti, 2007), and the resulting lack of formal

registration status has been shown to be a key determinant of variations in growth rates between enterprises (Capelleras et al., 2007).

3.5.2 Trust and informal constraints

A combination of uncertainty and weakness of the formal institutions responsible for contract enforcement is expected to result in trust-based coordination or cooperation between firms (Zhou and Poppo, 2008). Trust thus enables informal cooperation (Artz and Brush, 2000), that can act as an alternative to formal institutions and internalisation. The patterns of personal relationships within which these transactions are conducted are considered to be key to understanding organisational structures (Granovetter, 1985). However, if opportunism is added to the uncertainty and institutional weakness, then both trust- and contract-based coordination may be ineffective and firms may “simply select [sic] not to do business in such conditions” (Zhou and Poppo, 2008: 24).

Although informal constraints on behaviour can, on occasion, substitute for formal institutions, isolation can also result from the absence of informal restraints: “The higher these [transaction] costs [of formal enforcement], the more will the exchanging parties invoke informal constraints to shape the exchange, although in the extreme, of course, no exchange will take place at all” (North, 1990: 68). In the absence of both informal and formal constraints on opportunist behaviour, individuals trust neither the market nor their potential trading partners (Buckley, 1998).

In a study of China’s economic transition, an actor’s decision whether or not to trade with another was found to depend more on levels of environmental uncertainty (and the associated transaction costs), than on the cost of the goods or services traded (Keister, 2001). Levels of trade might be further reduced in the absence of informal

constraints on behaviour: “Parties choose to *not* work with others if broader social sanctions for misbehaving do not exist” (Zhou and Poppo, 2008: 24).

In summary, the degree of withdrawal from trade may range from a firm avoiding complex transactions, to reducing the number of transactions conducted or relationships maintained, or even remaining outside the formal economy. At the extreme, habitual withdrawal results in isolation of the firm, and an organisational structure compatible with self-reliance and non-specialisation.

3.5.3 Isolation as a gap in the literature and as a sensitising concept

The literature examined above offered ideas as to how the concept of isolation could be explored further, but without providing a precise definition. The author considered this to be a gap in the literature, and a suitable starting-point for the further exploration of an apparently under-researched phenomenon.

A definitive concept refers precisely to what is common to a class of objects, by the aid of a clear definition in terms of attributes or fixed bench marks.... *A sensitizing concept* lacks such specification of attributes or bench marks and consequently it does not enable the user to move directly to the instance and its relevant content. Instead, it gives the user a general sense of reference and guidance in approaching empirical instances. Whereas definitive concepts provide prescriptions of what to see, sensitizing concepts merely suggest directions along which to look (Blumer, 1954: 7, emphasis added).

In the subsequent empirical research for this study, the author therefore used isolation as a sensitising concept to guide the exploration of firms’ responses to transaction costs, without prescribing in advance a mechanism for measuring degrees of isolation. This corresponds with the strategy of enquiry based on the principles of critical realist ethnography, and the abductive inferences to be made (Blaikie, 2000), that will be described in Chapter 5. The observation, description, analysis and reporting of the empirical findings will contribute to the development of this concept,

as recommended by Blumer, culminating in its refinement as a “grounded concept” (Bryman, 2008: 541).

3.6 Research questions

The findings of the exploratory study proved critical to the shaping of research questions that are very much grounded in the context (Robson, 2002), particularly in the identification of isolation from other firms as a form of response to transaction costs that has received little attention in the literature, and in suggesting that institutions were important in shaping firms’ choice of response. The resulting research questions are:

1. Which causes of transaction costs are perceived by decision-makers in the firms studied?
2. How do the firms respond to these transaction costs?
3. Could an understanding of local institutions help us to explain firms’ responses to transaction costs?

The first research question draws on the literature to ask which of the causes of transaction costs are perceived by participating firms. The second question asks which responses to transaction costs are evident in the field, including the somewhat neglected area of isolation as a possible response to transaction costs. This may shed light on the reasons why the literature appears to lack a detailed examination of isolation, and it answers calls for research into business isolation in the absence of effective social constraints (Zhou and Poppo, 2008). The third question draws on the suggestion of the exploratory study, that institutions might be an important influence on firms’ responses and so help to explain the unexpected response of isolation. The relationship between transaction costs and institutions will be discussed in the next chapter.

CHAPTER 4 INTEGRATING INSTITUTIONAL THEORY INTO TRANSACTION COST THEORY

An alternative perspective on the findings of the exploratory study is presented by institutional theory, which opens up the possibility that institutional strength or weakness could affect the level of transaction costs and the range of responses that are available to firms. This is particularly important in an emerging market context, where institutions may be less developed than in the economies in which business research has typically taken place before (Peng et al., 2008). We now examine the scope of institutional theory to address this in the current study, describe the second of two observed gaps in the literature, and explain why the outcome of isolation is considered to be important.

4.1 Overview of new institutional theory

Institutional theory offers a way of understanding the reasons for the emergence or adoption of organisational forms, and so is pertinent to our study of the forms adopted by firms in response to transaction costs. Scott (1987) warns that “the beginning of wisdom in approaching institutional theory is to recognise at the outset that there is not one but several variants” (p493), but Bjorkman et al. (2007) offer an initial orientation for international business research: “a common point of departure for most scholars is that organisations are under pressure to adapt to and be consistent with their institutional environment” (p432). This is variously expressed as the influence of the institutional framework on organisations’ evolution (North, 1990), the role of the local context in which firms are embedded in the shaping of their economic behaviour and ability to respond to challenges (Locke, 1996), the institutional constraints on firms’ selection of an efficient structure (Roberts and

Greenwood, 1997), and a pressure on the subsidiary to conform to the expectations of the multinational enterprise's home context (Morgan and Kristensen, 2006).

The evolution of institutional theory has broadened the scope of institutions to which firms are thought to adapt. Prior to the 1970s, the literature of both institutional economics and institutional sociology focused on the process of organisations' conformance to their regulatory environments (Scott, 1995). This study focuses on the New Institutionalism of the mid-1970s onwards, because of three key changes: the inclusion of cultural institutions, the differentiation between institutions and organisations, and a focus on transactions. Scott (1987) credits Meyer and Rowan (1977) as being the first writers to go beyond regulatory institutions by incorporating cultural elements of institutions as influences on organisational structure, including cognitive systems and normative beliefs. This marked the emergence, alongside the existing Rational Choice Institutionalism, of Sociological Institutionalism (Hall and Taylor, 1996). Whilst the former had expected organisations to maximise their material well-being, the latter now added cultural explanations to changes enacted by organisations. Secondly, a clear distinction emerged at this time between the previous conflation of the concepts of institutions and organisations (Scott, 1995). This differentiation is critical to any analysis of the influence of institutions on firms, and is clearly illustrated by North's (1990) metaphor of institutions as the "rules of the game", and organisations (including firms) as the players (p3). Thirdly the new institutionalism in economics, which considered the influence of institutions on the structures and performance of individual organisations, included the influence of transaction costs on the placement of transactions in the market or the firm, and consequent changes to the boundary of the firm (Williamson, 1975). The new institutional theory, in both the economic and sociological schools, is therefore pertinent to this study's concern with "the interaction among institutions, organisations and strategic choices" (Peng et al., 2008: 922). The schools vary in the

emphasis they place on each of the institutional “pillars” (Scott, 1995), which are described in the next paragraph.

This broadened scope of institutions endures. It is encompassed in changes to the organisational structure that may be externally imposed (through government regulations or parent-firm authority) or deliberately acquired (to emulate examples considered to be successful or appropriate) (Scott, 1987), and in the coercive, mimetic and normative isomorphic processes whereby organisations become increasingly similar (DiMaggio and Powell, 1983). These can in turn be mapped onto Scott’s (1995) three pillars of institutional processes: the regulatory, cultural-cognitive and normative pillars respectively (Bjorkman et al., 2007), that both enable and constrain behaviour (Hodgson, 2006). Roberts and Greenwood (1997) consider firms’ efforts to maximise efficiency to be constrained by both regulatory and cognitive limits, which their constrained efficiency framework seeks to illustrate. For example, it attempts to offer a fuller explanation of the satisficing (rather than optimising) decisions that firms make due to the cognitive constraint of bounded rationality. This twofold typology is frequently employed in the study of constraints, with the terminology being abbreviated to formal rules (the regulatory pillar) and informal constraints (the remaining two pillars):

Institutions are the rules of the game of a society [,] or more formally are the humanly-devised constraints that structure human interaction. They are composed of formal rules (statute law, common law, regulations), informal constraints (conventions, norms of behavior, and self imposed codes of conduct), and the enforcement characteristics of both (North, 1994b: 1).

This distinction between informal and formal institutions is characteristic of new institutional economics (Alston, 2008, Rao, 2003). It is employed in conceptual (Dunning and Lundan, 2008, Pinkham, 2009) and empirical international business research (Dikova et al., 2010), and in emerging markets applications (Peng et al.,

2008). These emphasise that resources, capabilities and markets are necessary but not sufficient for economic growth, which also depends on the incentives and enforcement of institutions to guide their use (Dunning, 2006). The distinction will further be employed in this study's examination of the institutional environment to which firms adapt and by which they are constrained.

It should be noted that the scope of the author's attempt to integrate transaction cost and institutional theories is limited to investigating the institutional influences on transaction costs, and any intervening role they may play between the causes and outcomes of transaction costs. It does not extend to the discussion of institutional theory beyond its application to organisational structures and transaction costs, nor to a comparison of the predictive value of the two theories of institutions and transaction costs. For such comparisons, see the conceptual model of Martinez and Dacin (1999), or empirical studies such as Puck et al. (2009). Whilst much of the work that has previously been done on integrating transaction costs and institutions has been in the field of market entry-mode decisions, the business decisions we seek to understand concern the placement of transactions by firms as going concerns. This emphasis in international business research on institutional effects on the costs of conducting business is supported by Henisz and Swaminathan (2008), and is consistent with Mudambi and Navarra's (2002) concern for the effect of institutions on the "relative transaction and coordination costs of production and innovation" (p636). This study responds to a call by Powell (1991) for "research [that] would focus on why less than optimal arrangements persist over time" (p183) – which the author interprets as an invitation to explore the reasons for isolation in the study site.

4.2 The benefits of theoretical integration

By integrating the transaction cost and institutional theories, the author draws upon the relative strengths of both to explore the effects of institutions on transaction

costs, and the possibility of a moderating effect by institutions on the relationship between transaction costs and firms' responses to them. The combination will also help to address the critiques of transaction cost theory outlined in Chapter 2, some of the issues raised in the exploratory field study in Chapter 3, and to answer the call for more empirical research into both transaction costs and institutions (Williamson, 2000).

4.2.1 The impact of institutions on the level of transaction costs

The view that institutions affect the level of transaction costs makes it necessary to consider transaction costs and institutions in combination (North, 1990, Williamson, 1991). North (1994a) credits Coase (1960) with being the first to link strong formal institutions to transaction costs, by means of enforcing contracts, protecting property rights, imposing the rule of law, and avoiding corruption. Property rights and liability rules are identified as society's most important institutions, whose efficiency helps to reduce transaction costs (Rao, 2003). The key to this is the role of institutions in reducing the transaction costs caused by uncertainty of the environment and of behaviour (North, 2003), both of which were observed in the exploratory study. The means by which they might do this will be explored in section 4.3.

Transaction costs vary with the level of institutional protection afforded by different countries (Coeurderoy and Murray, 2008), and different countries provide different "institutional infrastructure, which determines to a large extent the context within which firms operate" (Chong and Gradstein, 2006). Emerging markets are characterised as having undeveloped institutional structures for the functioning of labour, product and capital markets (Palepu and Khanna, 1998). These "institutional voids increase transaction costs significantly" (p71), because of information asymmetry and weak contract enforcement. This geographic variation has prompted the author to seek an original research site with potentially weak formal institutions.

4.2.2 Intervention by institutions on firms' responses to transaction costs

Institutional theory offers an alternative perspective on the consequences of transaction costs, proposing that the strength or weakness of institutions might restrict the range of responses that are available to firms (Roberts and Greenwood, 1997). The potentially weak institutions in emerging markets (Luo, 2007) might make some of the responses predicted by developed countries' theory undesirable or impossible (see section 2.4.1).

North (1990) believes that institutional theory can help to explain behaviour, and in particular the decision whether or not to cooperate in response to transaction costs, where other theoretical approaches have failed. In his view, neoclassical economists' behavioural assumptions of rational choice and expected utility do not help us to understand the motivations of economic actors because in a complex environment, each actor will have incomplete information and will interpret it differently than others would; institutions can reduce this uncertainty. Although game theory predicts "the gains from cooperating and defecting in various contexts, it does not provide us with a theory of the underlying costs of transacting and how these costs are altered by different institutional structures" (North, 1990: 15).

In their review of organisational decisions based on comparative efficiency, Roberts and Greenwood (1997) draw all three institutional pillars into their constrained-efficiency framework, showing that firms aim to maximise the efficiency of their structures but are constrained in the choices open to them. Martinez and Dacin (1999) emphasise the informal or social element of these constraints on an otherwise economic response to transaction costs, and Oliver (1991) identifies social conventions that cause firms to make decisions that are not in their own best interests – just as the self-reliant behaviour in the research site may not serve the firms' future

growth needs. The means by which these informal constraints affect firms' decisions are explored by Yiu and Makino (2002) who interpret the normative pillar as limiting firms' actions to conformity with that which is commonly understood to be appropriate, and the cognitive pillar as the cognitive structures, schemas and stereotypes that decision-makers use to interpret the environment, resulting in greater use of strategies that have been used before, by their own firm or by other firms.

4.2.3 Reconciliation of the under- and over-socialised explanations

As discussed in Chapter 2, transaction cost theory has been criticised for concentrating on firms' aim of maximising efficiency whilst disregarding the role of social relations, whereas sociological institutionalism has been faulted for privileging constructed normative and cognitive processes at the expense of realist regulations, and rejecting the idea that structures might result from rational choice (Scott, 1995). This leads the author to consider transactions neither to be determined by purely economic motives, nor by conformance to norms alone (Granovetter, 1985). Neither school of thought's predicted response to transaction costs is sure to come about: the economic view assumes the presence and strength of formal institutions, and the sociological view is predicated on norms of trust being stronger than might be the case in China; nor can either school fully explain organisational behaviour (Martinez and Dacin, 1999). Granovetter's (1985) argument is that economic behaviour is embedded in interpersonal relations, which avoids the extremes of the under- and over-socialised views of the economists and sociologists respectively. He considers internalisation to be less effective at reducing opportunism than social relations between firms, and that internalisation occurs only where there is pressure for it in the absence of these social relations, and where the necessary resources are available.

4.2.4 Adaptation of transaction cost theory to the Chinese context

Where transaction cost theory has been criticised for making behavioural assumptions that might not apply in all cultural contexts, this study will use an institutional framework to examine its suitability to the research context. Management theory developed in the West often cannot simply be applied without adaptation in emerging economies (Wright et al., 2005) or in China (Leung et al., 2009). The increasing research interest in emerging markets over the past ten years has been accompanied by the recognition that understanding strategic choice here would require the addition of institutional theory to the more routine transaction cost, agency and resource-based approaches. These formed the guiding structures for special issues on strategy in emerging markets of the *Academy of Management Journal* (Hoskisson et al., 2000) and the *Journal of Management Studies* (Wright et al., 2005).

Researchers have noted that transaction costs can be particularly high in emerging economies, and some explain this as the result of the weakness or uncertainty of institutions (Meyer and Peng, 2005, McDonald and Vertova, 2002), which are needed to enable people to measure, share, reduce and hedge against risk (Clever, 2007). Weak formal institutions raise costs when individuals divert their own resources to make up for society's failure to promote law and property rights, and to protect them from exploitation (Williamson, 1975). Clever (2007) illustrates the costs of insecure contract and property rights: raising the risk – and so the transaction costs – of investment, and preventing a stronger contribution to growth from the informal sector, where lack of title and thus collateral prevents individuals from raising credit. High transaction costs can arise from the bureaucratisation of planned economies, including rent-seeking by officials that is made possible by weak law enforcement (Rao, 2003). The need to take into account the quality of institutions in evaluating transaction costs, is illustrated using the example of the weakness of law

enforcement in emerging markets and the regional variation in enforceability in China in particular (Luo, 2007). Luo (2007) explains Chinese regional variation in terms of degrees of economic development, where less-developed regions generally have weaker legal protection and enforcement, and more corrupt courts. Another type of transaction cost results from the absence of the rule of law, in the context of Chinese privately-owned business:

Worrying about the possibility of government predation, private owners rationally hide excessive revenue by choosing short-term or liquid projects. This provides incentives to managers but also incurs revenue-hiding costs (Qian, 2003: 312).

Several studies have used institutions to deepen their understanding of how firms cope with transaction costs in China. For example, long-term social connections and *guanxi* are used to reduce transaction costs of uncertainty (Keister, 2001), joint-venture contracts are adjusted to reflect the institutional context in order to reduce transaction costs (Luo, 2005), transaction cost and institutional theories are combined to explain firms' decision to change structure from joint ventures to wholly foreign-owned enterprises (Puck et al., 2009), kinship networks are used to reduce transaction costs and protect property rights in the context of undeveloped market institutions (Peng, 2004), and the transaction cost implications of contractual or trust-based governance are examined in the presence of weak legal institutions (Zhou and Poppo, 2008).

Of the three institutional pillars, Ang and Michailova (2008) found the regulatory pillar to be the most influential in deciding the governance structures of cross-border alliances where the host country is an emerging market with high regulatory uncertainty. Regulatory institutions were the least important in deciding structures in developed host countries, where regulations are likely to be stable and the normative pillar is key to mimetic isomorphism. China's weak and ever-changing legal system

has been found to have strong effects on governance choices (Zhou and Poppo, 2008, Ahlstrom et al., 2003). Small firms are also found to be particularly constrained by weak formal institutions including government regulation, access to finance and lack of protection from externalities and powerful industry or market players (Morrison et al., 2003). When their development is thus constrained, these firms' contribution to employment growth, income generation and economic development remains limited (Smallbone and Welter, 2006).

The inclusion of informal institutions has also been recognised as being vital to the research into strategic choice in emerging markets (Trevino et al., 2008), and firms' performance in emerging markets including China (Peng et al., 2008). If such a context has weak formal institutions, the social capital embodied in managers' informal ties with external organisations can be all the more important to performance (Peng and Luo, 2000). Informal institutions of trust and reciprocity in exchange contribute to the reduction of transaction costs and so to the development of rural enterprise in China (Hu, 2007). Informal ties serve to attenuate transaction costs relating to uncertainty and opportunism, and result in relational rather than contract-based governance (Zhou et al., 2008).

Despite these examples, Meyer and Peng (2005) see room for further development of the theoretical integration between transaction costs and institutions, citing "the potential value in exploiting institutional variation to better understand the nuances and limitations of TCT [transaction cost theory]" (p603). This is a challenge that this study attempts to take on.

4.3 How institutions affect transaction costs and firms' responses

This study considers various elements of formal and informal institutions, in their impact on levels of transaction costs and as potential constraints on firms' responses to these costs. Whereas North's formal institutions or Scott's regulatory pillar are generally explored in terms of political, financial and legal institutions (Guler and Guillen, 2010, Djankov et al., 2006), here the author specifically explores the hindrance to firms by inefficiency or arbitrariness of local governments, the availability of funding to finance internalisation, and the perceived reliability of the legal system to enforce contracts and property rights or protect parties to transactions.

The author anticipates, however, that informal institutions might have more influence on the small firms researched, to whom the government may appear distant (Levitsky, 1989). These draw on North's conception of informal institutions, and so equally on Scott's cultural-cognitive and normative pillars. The informal institutions addressed include trust, kinship, social networks, *guanxi* and sanctions.

4.3.1 Formal institutions

North (1990) describes market institutions as a "mixed bag... some increase efficiency and some decrease efficiency" (p69) – reminding us that weak institutions can constrain productivity and raise transaction costs just as readily as stronger institutions can reduce them. Institutions shape incentive structures for production (Olson Jr., 1996), which then direct the type of production, learning and growth that is achieved (North, 1994b): if the incentive structure is focused on redistribution rather than production, opportunism is expected to result.

4.3.1.1 Local government

The economic and political reforms in 1980s China included decentralisation of government powers, resulting in the transfer to local (provincial, county or township) governments of policy areas directly affecting local life. This left a “myth of the strong central state” (Schortgen, 2009: 28), that is both remote from the firms in this research context (Levitsky, 1989) and impacts upon them less directly than local government (Smallbone and Welter, 2006). However, the township governments’ evolution from Mao-era communes has retained fundamental problems:

Although the commune has been dismantled as a political economic unit, its institutional successor, the township, is now popularly regarded as the most corrupt level of government. ... The combination of the township’s institutional weakness in its preceding communal incarnation and budgetary pressures created by reform-era fiscal decentralisation have inspired a variety of local developmental strategies – some of which are predatory (Tsai and Cook, 2005: 61).

Small firms in emerging markets may have little chance of accessing positive government support (Elkan, 1995), but this is almost certain for privately-owned firms in China as resources are directed to state-owned firms (Luo, 1997). The influence of Chinese local government on firms is described as uncertain or unpredictable, with implications for the transaction costs of bounded rationality and uncertainty, to the point of hindering business operations (Zhou and Poppo, 2008, Peng, 2004). This might be caused simply by inefficiency in the bureaucracy (Rao, 2003), by arbitrary enforcement of unclear regulations (Child and Moellering, 2003) that may change more quickly than firms can keep up with them (this transaction cost of information search was reported to the author by two foreign-invested enterprises (FIEs) in Chengdu, in 2006), or by deliberate discrimination against enterprises (Peng, 2004). It may result in a loss of confidence by firms in the honesty of local government representatives (Child and Moellering, 2003), and even firms

resorting to networks or red-capping (presenting a private firm as a collective enterprise) in an attempt to protect themselves from predatory officials (Peng, 2004).

4.3.1.2 Funding

In order for firms to finance growth or internalisation, they must have access to external funding at reasonable cost (Smallbone and Welter, 2006). This has been found to constrain the growth of firms in a similar research setting to our own – small, family-owned tourist accommodation businesses, in a developing region of Poland (Zapalska and Brozik, 2006). Whilst emerging economy banks may often have insufficient funds to lend to small firms due to a low level of deposits (Elkan, 1995), the Chinese have built up high saving rates even in the presence of negative real interest rates (Economist, 2009b). However, Chinese banks tend not to pass on these deposits to small or private firms (Peng, 2004), instead being directed to offer far cheaper credit to state-owned firms (Economist, 2009a, Li and Xia, 2008). Zhu (2007) even describes the purpose of China's banking sector as being the support of state-owned enterprises. Small private firms' lack of credit records (Poutziouris et al., 2002) and property rights prevents them from accessing bank lending in China (Bai et al., 2006, World Bank, 2008) just as in other developing countries (Clever, 2007), and larger private firms may pay a high price – in terms of time and financial cost – to formally register collateral (World Bank, 2008). The lack of lending to small firms is particularly acute in rural areas, despite government attempts since 2005 to support rural and private sector development through improved access to finance, partly because this conflicts with another government demand: that this lending should be based on thorough credit-risk assessments (Herd et al., 2010).

Peng (2004) explains that because Chinese entrepreneurs struggle to obtain formal bank loans, they resort to informal borrowing – mirroring the findings of Zapalska and Brozik (2006). This is reported to lead to lower transaction costs if accompanied

by enforceable trust, but access and available amounts will vary with individual circumstances. It usually takes the form of small loans based on personal relationships between relatives or friends, with no interest charged (Hu, 2007), and is the main source of finance for Chinese SMEs and farmers (Herd et al., 2010). This constraint on funding may hinder firms' investment for growth, or even their participation in the formal market (Mair and Marti, 2007). Further financial institutional support that may be lacking includes purchasing on credit at reasonable terms (Atradius, 2008) and insurance for healthcare costs and buildings (in the context of the 2008 Sichuan earthquake).

4.3.1.3 Legal system

This section concerns the reported reliability of the legal system to enforce contracts and property rights or to protect parties to transactions – so reducing transaction costs and enabling firms to use contracts and internalisation to respond to them. However, in China contract law has historically had limited effect in constraining opportunism, and enforcement costs are high (Hoskisson et al., 2000). Commercial and civil law are not yet well developed, property rights and the limits to officials' authority are ambiguous, and commercial disputes are often resolved informally or even forcefully (Ahlstrom et al., 2003). Despite the considerable progress made since the 1980s in reforming the legal system, inconsistencies between laws and regulations remain, and there are regional discrepancies in interpretation and enforcement (Ojito, 2003). Chinese firms often rely on trust-based relationships to safeguard their business interests, because of historical habit (Zhou and Poppo, 2008) and because they have little confidence in the variable effectiveness of the legal protection or remedies available (Luo, 2007). Time will tell whether the second judicial interpretation of China's Unified Contract Law (1999), which came into effect in May 2009, will have

the anticipated effect of reducing uncertainty in contractual relations (Thomas, 2009).

The first legal hurdle for firms to clear is formal registration, and high costs of registration may act as a barrier to entry by new firms (Clever, 2007). Once registered and conducting trust-based trading, fast-growing firms will need to extend into contractual trading and so leave behind the protection of the reputation effect (Douma and Schreuder, 2008). This transition is dependent on the perceived reliability of legal enforcement (Zhou and Poppo, 2008), and of the accuracy with which legal documents describe the trustworthiness of an individual or firm (de Soto, 2006), which is fundamental to achieving a system of impersonal exchange that encourages repeat transactions rather than cheating (North, 2003). This reflects North's (2003) expectation that sound institutions should be able to reduce the transaction costs of opportunism in addition to uncertainty. Firms will assess the reliability of the legal system in deciding whether their transactions would better protected from opportunists by trust-based or contractual governance structures, but may prefer to resolve disputes through relational rather than legal means (Zhou and Poppo, 2008). Granovetter's (1985) view of formal institutions that deter opportunism is, "They do not produce trust, but instead are a functional substitute for it" (p489) – which would make functioning institutions all the more valuable in contexts where trust is limited.

Whilst North (1994b) anticipates lower transaction costs in the presence of strengthened broader legal institutions – protected property rights, the rule of law, the absence of corruption – Khanna (2007) points out that the enforcement of property rights is still uncertain in both urban and rural China. On October 1st 2007 China's new Property Rights Law came into effect, offering equal protection to state, collective and private property; however, its ambiguity led to expectations that its

implementation would be subject to local interpretation (Marechal et al., 2009). The new law allows the renewal of farmers' land-use rights (rural land still being owned by collectives), but does not allow for their sale or mortgage (Economist, 2008) – denying rural residents the incentive to invest in land and the means to raise finance for such investment. Such residents risk expropriation for urban development or infrastructure projects (Bai et al., 2006) and insufficient compensation (Khanna, 2007).

North (1994a) rightly observes that contracts need to be enforceable in order to be worthwhile, but Poppo and Zenger (2002) find that transaction costs can be further lowered by supplementing contracts with relational governance, where parties have developed trust and can rely on relational norms. This is illustrated in the Chinese context by Zhou and Poppo (2008) who found cases where firms would not enter into a contract unless they could trust the counterparty to honour it, as they had no expectation of legal enforceability.

Formal institutions can help to control externalities, which are unintended consequences of production that affect third parties but go uncompensated. These externalities persist and are not internalised by firms, when prohibitive transaction costs are involved which might include contract provisions for liability rights such as penalty clauses (Rao, 2003). Milgrom and Roberts (1992) illustrate this using pollution as an example of an externality, which the exploratory study had shown to be a concern in the research site. If the sufferers of pollution were to attempt to charge firms for the pollution they cause the negotiations would entail unreasonably high transaction costs, so instead governments specify and enforce environmental standards to protect all potential sufferers. These regulations thus avoid the need for individuals to incur transaction costs of obtaining protection, and reduce the transaction costs of negotiation or compliance by the party causing the externality.

In our discussion above, we have examined the effects of formal institutions on transaction costs, but it should be noted that they require the support of informal institutions in order for them to be optimally effective. Hodgson (2006) expresses this in terms of laws that are ineffective until they become incorporated into social norms and Dunning and Lundan (2008) propose that it would be pointless to study formal institutions in isolation from the underlying informal institutions. This means that the pace of institutional change is heavily influenced by informal institutions: “While the formal rules can be changed overnight, the informal norms change only gradually” (North, 1994b: 3). Yang and Temple (2002) report that this was taken into account during China’s reform period.

4.3.2 Informal institutions

Scott (1987) defines social institutions as enduring systems of beliefs and practices, encompassing cognitive, normative and behavioural systems. These systems include the norms that define the legitimate means by which one may pursue the desired ends, and the cultural-cognitive rules used to interpret and to constrain behaviour. In the context of organisations, these systems can dictate behaviour “through the exercise of habit, convention, convenience, or social obligation” even when it runs against the organisation’s own interests (Oliver, 1991: 151), which the current author interprets as constraining how firms can respond to transaction costs. In the context of doing business in China, Tseng and Kuo (2008) consider normative institutions to include the practice of settling transactions in cash, the standards of commercial and competitive behaviour, labour norms, and the ineffectiveness of legal enforcement. Their interpretation of cognitive institutions focuses on the use of *guanxi* to obtain influence, whilst the current author takes a slightly broader view of *guanxi* and kinship relations as culturally-determined structures within which trust may develop.

The sections that follow examine the effect that various informal institutions might have in reducing transaction costs and enabling firms to respond to transaction costs, or conversely, in increasing transaction costs or constraining firms' options. Consideration is also given to the scope for informal institutions to act as substitutes for weak formal institutions. North (1990) considers that where a developing economy lacks the financial, legal and political institutions that would normally be drawn on in the course of contract enforcement, some of the gaps can be made up for by informal institutions. This view is repeated with reference to the Chinese context (Li et al., 2008b, Poutziouris et al., 2002, Peng et al., 2008, Hu, 2007). North (1990) considers property rights to be an exception to this proposition, but Peng (2004) offers an example of this working in China (see section 4.3.2.3). Poppo and Zenger (2002) suggest that contracts themselves, and the alternative governance form of vertical integration, can be replaced by the self-enforcing safeguards of trust and relational norms of behaviour.

4.3.2.1 Trust

This section considers how the development of trust affects its impact on the level of transaction costs, whether it enables cooperation as a response to transaction costs, its ability to substitute for weak formal institutions, and negative consequences of trust-based exchange.

Trust is evident in economic exchange when actors expose themselves to the risk of opportunism by their counterparties, because of their expectation that the counterparty will not take advantage of them (Humphrey and Schmitz, 1998, Locke, 2001). Trust can affect the levels of transaction costs associated with contracting and opportunism (Poppo and Zenger, 2002), and can exist at various levels (Rao, 2003). Degrees of interpersonal trust can be influenced by culture – some traits increase transaction costs (kinship leading to cronyism), while others reduce transaction costs

in personal exchange (reputation, credibility, formation of expectations). This is the micro-level of trust described by Humphrey and Schmitz (1998), and might be extended within the family (Fukuyama, 1995), kinship network (Peng, 2004), social network (Child and Moellering, 2003), or beyond. Trust may be confined to others considered to be similar, or to those who are different and might bring complementary benefits to a transaction (Lewicki and Bunker, 1996). Between the micro and macro levels, generalised trust applies to all individuals in a social group (Knight, 2001); this entails a shift from trust developed through acquaintance to trust through description (de Soto, 2006). To reduce the uncertainty and transaction costs of impersonal exchange, macro-level or institutional trust by individuals in formal institutions is also needed (Humphrey and Schmitz, 1998), as is trust amongst firms (Zaheer et al., 1998), and between economic entities, state and society.

In distinguishing between types of trust, Barney and Hansen (1994) differentiate between the weak trust exhibited by people who do not fear opportunism because they do not acknowledge vulnerability, the semi-strong trust of those who have confidence in contractual safeguards employed to avoid opportunism, and the strong trust of those who are confident that their vulnerabilities will not be exploited even in the absence of contractual safeguards. Cooperation based on strong trust avoids the contracting costs inherent in forming semi-strong trust (Steensma et al., 2000). Granovetter (1973) divides the value placed on strong or long-standing ties, from recently-formed or weak ties that might be valued for their potential benefits to business. Humphrey and Schmitz (1998) describe a range from “minimal trust” as the minimum degree of trust that is required for a market economy to function, which can be lacking in emerging markets, to the “extended trust” that is required for the integration of global supply chains.

Regarding the development of trust in business relationships, Western conceptions can assume a progression from arm's length transactions through knowledge of the counterparty to trust (Lewicki and Bunker, 1996), which contrasts with Chinese authors' views that the trust relationship routinely precedes transactions (Zhou and Poppo, 2008). Dikken and Harris (2001) consider the alternatives of whether trust always precedes trade or trade leads to trust, in an apparent parallel to the sociological and economic views of trust (Locke, 2001). In the former view, the pre-existing relationship is expected to survive a termination of trade. Dikken et al. (2003) expect dispositional trust – determined by the truster's personality – to develop only in the absence of situational trust which is produced by repeated interaction within a given context; Hardin (2001) sees limited benefit arising from dispositional trust alone. The current author's view is that easily-formed trust will more readily contribute to lower transaction costs.

The business benefits of micro-level trust centre on a reduced expectation of opportunism, and so a reduction in the transaction costs of contracts intended to avoid it (Fukuyama, 1995, Steensma et al., 2000); a strategy of cooperation is also made possible by a trusting relationship (Steensma et al., 2000). Macro-level trust in firms and market institutions is expected to reduce the uncertainty and the risk of opportunism in impersonal exchange, and thus the need for complete (high transaction cost) contracts (Rao, 2003). Zhou and Poppo (2008) focus on trust between firms to reduce transaction costs, by enabling a firm to rely on its partner's fair and predictable behaviour, and by promoting a common, long-term outlook without the need for constant monitoring. Zaheer et al. (1998) explain that inter-firm trust reduces the transaction costs of contracting, by reducing the need of each party to take precautions against opportunism by the other party. Pre-contractual negotiations can thus be briefer – as also demonstrated by Dyer and Chu (2003) – and post-contractual contingencies can be resolved “without resorting to legalistic

remedies” (p146). Regarding asset specificity, Artz and Brush (2000) expect that trust can reduce the extent and therefore cost of contract negotiations by virtue of minimising the risk of opportunism. In addition to reducing the transaction costs that stem from opportunism, Madhok (1995) finds that trust limits the environmental transaction costs that are due to small numbers bargaining and uncertainty.

McDonald and Vertova (2002) suggest that in developing countries where the institutional environment has caused high transaction costs, they can be reduced by supplementing the business network with a social network element. Buckley (2004: 268) applies this to business in China, describing the Chinese family as “an island of high trust in a low trust society”, and family firms as “a response to an imperfect (corrupt) society. Corruption raises transaction costs, and networks represent islands of low transaction costs in a sea of high transaction costs”. Hu (2007) emphasises the vital importance of trust acting as a substitute for the legal system that is largely absent from rural China.

However, despite their benefits in personal exchange, the time taken to develop these trust relationships (Keister, 2001) and their near-restriction to kinship groups (Fukuyama, 1995) constrain their effectiveness in promoting impersonal exchange and business growth; this leads us in to the next section on kinship. Trust may have a further detrimental effect on the inclusiveness and cost of trading:

Trust, however, as a foundation for economic relations, is a ‘double-edged sword’: it can retard economic development where it is a strictly *private* form of transactional coordination, as in the case of mafias or aristocracies, for these, by definition, restrict the entry of new producers; where trust is highly generalised and public, on the other hand, it serves to sustain transactions and reduce the costs for established producers, while at the same time allowing new entrants into the community (Storper, 1991: 112).

4.3.2.2 Kinship

The social element of the business network referred to in the previous paragraph, may be understood in China as concentric circles of relationships, with immediate family at the core, surrounded by close and then more distant blood-ties, then social ties within a village, and more remote “external bridging ties” radiating outwards from the village (Peng, 2004). The outermost ring comprises the more commercially- or politically-oriented *guanxi* connections, which will be discussed in the next section. Hu (2007) similarly cites the family, extended family and village as the principal bases of trust in China. Peng (2004) distinguishes between the relationship-based definition of Chinese networks, and Western ideas of groups constituted of voluntary members who share common principles and qualifications for membership. Peng (2003) particularly warns that Chinese social networks should not be confused with the network strategies of developed-country firms:

Not all networks are the same. Whereas networks in emerging economies tend to be embedded in interpersonal ties, networks in developed economies, supported by more established formal institutions, tend to be more calculative, with more codification and transparency (Peng, 2003: 292).

The mechanisms by which these social relationships reduce transaction costs are the protection of property rights, deterring opportunism, facilitating cooperation and sourcing information through external ties. Kinship “remains the locus of collective action and normative control in contemporary China”, with the benefit of “enforceable trust” (Peng, 2004: 1051), which obliges members to cooperate and trade fairly, and can aid the resolution of disputes without the transaction costs of formal enforcement. A similar reduction in opportunism is expected between small Western firms whose proprietors share social bonds, with a consequent reduction in pressure to internalise (Buckley and Casson, 1998).

Whyte (1995) disagrees with Weber's depiction of family bonds as solely detrimental to the economy, arguing instead that they have also been a source of loyalty, motivation and performance contributing to China's growth since the 1980s. A further benefit to rural entrepreneurs of kinship networks is identified as the enforcement of informal property rights as a substitute for ineffective formal property rights and weak market institutions with their associated high transaction costs (Peng, 2004).

Although the trust inherent in kinship structures reduces the risk of opportunism, the boundary of these structures can in turn constrain the development of the firm. In Whyte's (1996) continued debate as to the relative merits of kinship in China's economic development, he finds some family firms reluctant to employ or even trade with outsiders: "There is prejudice against hiring nonrelatives to work in the family firm, even if they are quite competent... The difficulties of cooperating with nonrelatives outside the firm are also described as severe" (p4). This difficulty of extending trust beyond the kinship group is described as a constraint on the growth of firms, resulting in the dominance of small, family-owned firms in China, and hindering internalisation and the separation of ownership from control (Fukuyama, 1995).

4.3.2.3 Wider networks

The term "*guanxi* community" is used to describe a group or network based on social rather than family ties that may share attributes such as codes of conduct, ethnicity, religion, territory or dialect (Hu, 2007: 32). Hu equates it with the concept, widely used by Chinese people, of a "group of friends" (p57). Such ties may serve a commercial as well as a social purpose, and may then be characterised as business ties (between managers in customer, supplier or competitor firms) or political ties (between managers and government officials) (Li et al., 2008b); Peng and Luo

(2000) emphasise the importance of making this distinction in Chinese business research. The Chinese term *guanxi*, meaning “social connections”, describes a relationship with an overt business or political rather than purely social aim. Tseng and Kuo (2008) consider *guanxi* to be an element of the cognitive pillar that can be a critical supplement to the normative pillar, and *guanxi* are widely recognised as a means of maintaining influence, operational efficiency or competitiveness in China (see for example Li et al., 2008a, Douma and Schreuder, 2008). A Western viewpoint might suggest that where such relationships run vertically they can improve quality and cost of supply, as in the internalisation of intermediate product markets, but that horizontal relationships often lead to collusion (Buckley, 2004).

The current importance of *guanxi* in Chinese business stems from their historical importance in the coordination of economic exchange (Zhou and Poppo, 2008), and their ongoing potential for lowering the transaction costs related to opportunism compared to formal policing and enforcement (Peng, 2004). Luo (1997) proposes that information obtained via *guanxi* can be more reliable and incur smaller search costs than other sources. Peng et al. (2008) and Douma and Schreuder (2008) highlight China among developing countries, as a place where personal connections are an important substitute for less-developed institutions of governance and dispute resolution. The need for *guanxi* as an alternative to the formal bureaucracy, especially by private firms, is stated very plainly:

While the Chinese bureaucracy often inhibits action, *guanxi* facilitates action... *Guanxi* provides a balance to the cumbersome Chinese bureaucracy by giving individuals a way to circumvent rules through the activation of personal relations.... Collectively and privately owned firms have more difficulties [than state-owned enterprises] in gaining access to scarce raw materials and other resources and achieving governmental assistance and support. Good *guanxi* connections therefore constitute a substitute for institutional support in this circumstance (Luo, 1997: 46).

This reliance on political ties is supported by Li et al. (2008b) and by Xin and Pearce (1996: 1642) who found private firms to need a substitute for “formal institutional support” comprising reliable government, a stable regulatory environment and an established rule of law, which would otherwise enable them to conduct impersonal business transactions. Xin and Pearce (1996) go on to describe a defensive use of *guanxi*, as protection from threats of expropriation or extortion by officials.

The benefits of networks or *guanxi*, in reducing risk or transaction costs, should be weighed against their cost. Services performed by political contacts are favours that must be repaid (Li et al., 2008b). Peng (2003) and Douma and Schreuder (2008) illustrate the high marginal cost of each *guanxi*-facilitated transaction, suggesting that high-volume business is very expensive and a transition to arm’s length business would be more economical. Peng’s (2003) model predicts that a shift from network-based to rule-based, impersonal exchange will occur as market institutions mature. This reduction in reliance on networks is demonstrated in a longitudinal study of entrepreneurial growth during Hungary’s institutional transition (Danis, Chiaburu and Lyles, 2010). Zhou and Poppo (2008) fear that the transition to impersonal exchange might be hindered by China’s “tradition of using social relations to sanction economic exchanges” (p23). A stronger form of this concern describes a corrupt form of *guanxi* that is used as a “back-door” means of gaining advantage (Guthrie, 1998). Luo (2008) describes an increasing tendency for *guanxi* and corruption to overlap, causing increased levels of opportunism and bribery as the emphasis shifts from an exchange of favours to a power-based exchange. He expects the public perception of *guanxi* to deteriorate from a cultural to a rent-seeking practice.

Another possible cost of networks is that they may entail an opportunity cost greater than the saving they offer in terms of protection from opportunists outside the

network. Child and Moellering (2003) point out that, although economic relations in China are very dependent on trust, it is difficult to build trust beyond the boundaries of existing kinship or social networks – confirming the fears of Storper (1991) quoted above. Existing social ties can restrict firms' access to new opportunities that reside beyond the network (Poppo and Zenger, 2002), and a close network may be closed to inflows of new information from outside and so fail to adapt to changing demands (Uzzi, 1997). A further problem is gaining entry to a network of relationships, as “managers built new ties on existing relations, creating considerable path dependence in interfirm exchange” (Keister, 2001: 340). This is exacerbated by the differential development of the Chinese regions, where firms in slower-growth areas have more difficulty in accessing markets and competing. This is described as an effective barrier to entry for new firms, making them less able to compete against more established firms with extensive networks (Whyte, 1996).

4.3.2.4 Social sanctions

Trust has been defined as not expecting one's business partner to behave opportunistically, and sanctions as believing that one's partner might act optimistically and so developing rewards and penalties to make this unattractive (Humphrey and Schmitz, 1998). Where North (1994b) describes institutions as rules and their enforcement, sanctions serve as an informal enforcement mechanism of trading norms (Dunning and Lundan, 2008). Humphrey and Schmitz (1998) consider trust and sanctions to be complementary rather than mutually exclusive, together increasing the predictability of a party's actions and so facilitating exchange.

The accepted rules of behaviour are widely agreed upon in the community, and are enforced by a network of sanctions, both positive and negative, both economic and non-economic. The system is well suited to minimizing both transactions costs as well as risk of opportunistic behaviour (Mead, 1984: 1101).

Sanctions at the meso (within a trade association or informal network) and micro (between the parties to an individual exchange) levels could be either social or economic. The principal mechanism for meso and micro social sanctions is the reputation effect within a trading community. If members know that any short-term gains from opportunist behaviour will be offset by damage to their trustworthy reputation and a longer-term reduction in transactions, they will be deterred from such behaviour (Milgrom and Roberts, 1992). Greif (1994) expects this informal enforcement to be common in collectivist societies, whereas individualist societies would tend more towards formal institutions, and Peng (2004) confirms that maintaining one's reputation is an effective deterrent to dishonest behaviour in China. Zhou and Poppo (2008) call for further research to establish whether parties would elect not to trade in the absence of such social sanctions.

Prerequisites for sanctions to operate effectively in enabling trade include an element of trust, a shared understanding of the group members' common interests, sufficient autonomy to modify institutional structures, and communication (Ostrom, 1990). This latter point is emphasised by Douma and Schreuder (2008) as in order for exchange to be supported by trust in reputation, there must be a means of communicating information concerning reputations and their change over time. This leads Holstrom (2002) to expect the reputation effect to work in local groups.

Despite the transaction cost benefits and extended trading that can be made possible by social sanctions, these costs may in fact be increased and the number of potential trading partners reduced if "firms select exchange partners of known reputation and solicit relations that reduce uncertainty, even when there is a cost involved" (Keister, 2001: 336).

4.4 Second gap in the literature: empirical studies of the role of informal institutions in Chinese firms' responses to transaction costs

Transaction cost theory expects firms to adopt the governance structure that will most reduce the perceived transaction costs, which implicitly assumes that all the theoretical options are open to them in real life. Our review has shown that there are cases when the institutional context limits these options.

A number of the conceptual papers already cited postulate that institutions, in various forms, constrain firms in their choice of action. A broad interpretation, encompassing both formal and informal institutions, is employed by Hodgson (2006) and Roberts and Greenwood (1997) in their analysis of institutional constraints, and by Meyer and Peng (2005) in terms of less developed institutions in emerging markets. Mudambi and Navarra (2002) consider that formal institutions raise transaction costs by limiting firms' interaction, and Oliver (1991) sees informal institutional pressures hindering firms from acting in their own economic interests. In a conceptual paper specific to informal institutions in China, Luo (1997) describes the fear of losing social status as preventing firms from pursuing internalisation.

Empirical studies of the institutional constraints on the actions of firms in response to transaction costs in the Chinese context appear to be largely limited to firms' confidence in the effectiveness of formal institutions. For example, Child and Moellering (2003) focus on the conduct of government officials, and Zhou and Poppo (2008) examine the regional variation in the enforceability of contracts in firms' choices between contractual or trust-based governance. The author considers the lack of empirical studies of informal institutional constraints on firms' responses to transaction costs in China to constitute a second gap in the literature. Hu (2007) confirms that scholarly effort has tended to focus on China's "formal institutional

changes, such as government policy... very little attention has been paid to changes in informal institutions”, and describes his work on informal lending through rotating credit associations “as one of the very few attempts made in this area” (p28). Peng and Luo’s (2000) study is another such attempt, exploring the relationship between managerial ties and firm performance. Although these two studies address informal institutions, they do not fill the gap or duplicate the current author’s work, with the former focussing on informal bodies for lending rather than connections or trust, and the latter using quantitative rather than qualitative data.

The third research question asked whether an understanding of local institutions could help to explain firms’ responses to transaction costs, in terms of a possible mediating role between the causes of transaction costs and the responses of firms that range from internalisation to cooperation or even isolation. The incorporation into this question of both formal and informal institutions will contribute to addressing the second gap in the literature and it answers a call for research into the impact of informal (as well as formal) institutions on international business decision-making (Trevino et al., 2008).

4.5 Conclusion

This section explains why the author considers the response of isolation to be important, before closing with a summary of the research questions, the gaps in the literature, and a modified framework illustration.

4.5.1 Repercussions of isolation

For the individual firm, isolation will entail in-house production to meet all of the firm’s needs. It has long been recognised that this generalist approach will prevent the division of labour and the growth in productivity that should result from this

(Smith, 1776, Douma and Schreuder, 2008). As the firm fails to develop a specialist area of production in which it has a competitive advantage, it will fail to maintain or increase its ability to compete with other more efficient firms, and so risks decline rather than business development. A failure to specialise will also limit the contribution of the firm to economic growth, as:

Capitalist growth is achieved through increasing the 'roundaboutness' of production, that is, through increasing interfirm and interindustry specialisation, as well as increasing specialisation within the technical division of labour in a specific firm (Storper, 1991: 22).

Increasing specialisation and competitiveness are not considered to be synonymous with extensive firm growth, as they do not extend the boundaries of the firm; as such, avoiding isolation need not conflict with the preferences of some proprietors to keep their firm small (Nooteboom, 1993) or with the conservation of this rural research site.

Without specialisation, there will be no incentive to extend the patterns of exchange between firms, carrying implications for the development of the firm and the local economy. A transition from personal towards impersonal exchange is desirable in the longer term, to enable the firm to trade beyond the confines of a network that becomes increasingly expensive to maintain as it expands (Peng and Heath, 1996), and to promote local economic development as more numerous, more complex transactions could be conducted more efficiently (North, 1990). Self-sufficient producers who avoid participation in the market do not contribute strongly to economic development (Buckley and Casson, 1998).

We have seen that informal institutions can facilitate personal exchange, but dependable formal institutions would need to be present to protect the parties making a transition to impersonal trading. The powers of enforcement of legal institutions are a prerequisite for the transfer from trust-based to contractual trading (Zhou and

Poppo, 2008). An accompanying transition would be needed from personal trust in the counterparty to an impersonal trust in the formal institutions: once the trading group is too big for the reputation effect to work, legal structures must both be in place and be trusted (Douma and Schreuder, 2008). North (2003) sees this as key to achieving a system of impersonal exchange that encourages repeat transactions rather than cheating, which Williamson (1975) earlier described as “the invention of institutions that produced order out of conflict” (p3). The enforcement of impersonal transactions at low cost “is a necessary condition for capturing the gains from trade that were the keys to Adam Smith’s ‘Wealth of Nations’ ” (North, 1994b: 1).

4.5.2 Summary

The extant theory of transaction costs and institutions does not explain the business isolation observed in the author’s exploratory study. The literature appears to be focused on internalisation and cooperation, as examples of successful responses to transaction costs by growing firms. Too little attention is paid to the poor relation of integration and cooperation, namely isolation, which is mentioned but not discussed in detail or researched further. The exploratory study identified firms that neither cooperate nor internalise in response to transaction costs; instead they conduct a reduced number of transactions. This lower volume of trade prevents them from specialising, and so from capturing the benefits of specialised exchange. This study will proceed to examine the behaviour of these firms in depth, to explore the possibility that isolation might be a response to transaction costs.

It has further been observed that the theories of informal institutions have not been subjected to as much empirical examination in the Chinese context as the formal institutions. It seems unlikely that such an examination is unnecessary, given the attention paid by the conceptual literature to informal institutions, and so this study will contribute to this important gap by investigating how informal as well as formal

institutions affect the levels of transaction costs and constrain or shape firms' responses to transaction costs.

These two gaps are directly associated with the formulation of the research questions, which are restated here for the reader's convenience:

1. Which causes of transaction costs are perceived by decision-makers in the firms studied?
2. How do the firms respond to these transaction costs?
3. Could an understanding of local institutions help us to explain firms' responses to transaction costs?

The research questions and gaps in the literature have been incorporated into the modified conceptual framework, presented in Figure 5 below. The progression from our initial expectations from the transaction cost literature (illustrated in Figure 4) is shown by the insertion of institutions as intervening factors between the causes of transaction costs and firms' responses to them. The exploratory study and subsequent review of the institutional literature suggested that weak formal institutions could hinder the predicted responses of internalisation and cooperation, resulting instead in the unexpected outcome of isolation. Informal institutions are also thought to be able to act as substitutes for weak formal institutions, or to constrain firms' responses, so also contributing to an outcome of isolation.

In Chapter 5, we will show how a qualitative approach to transaction costs will be used to apply the theory to answering the research questions.

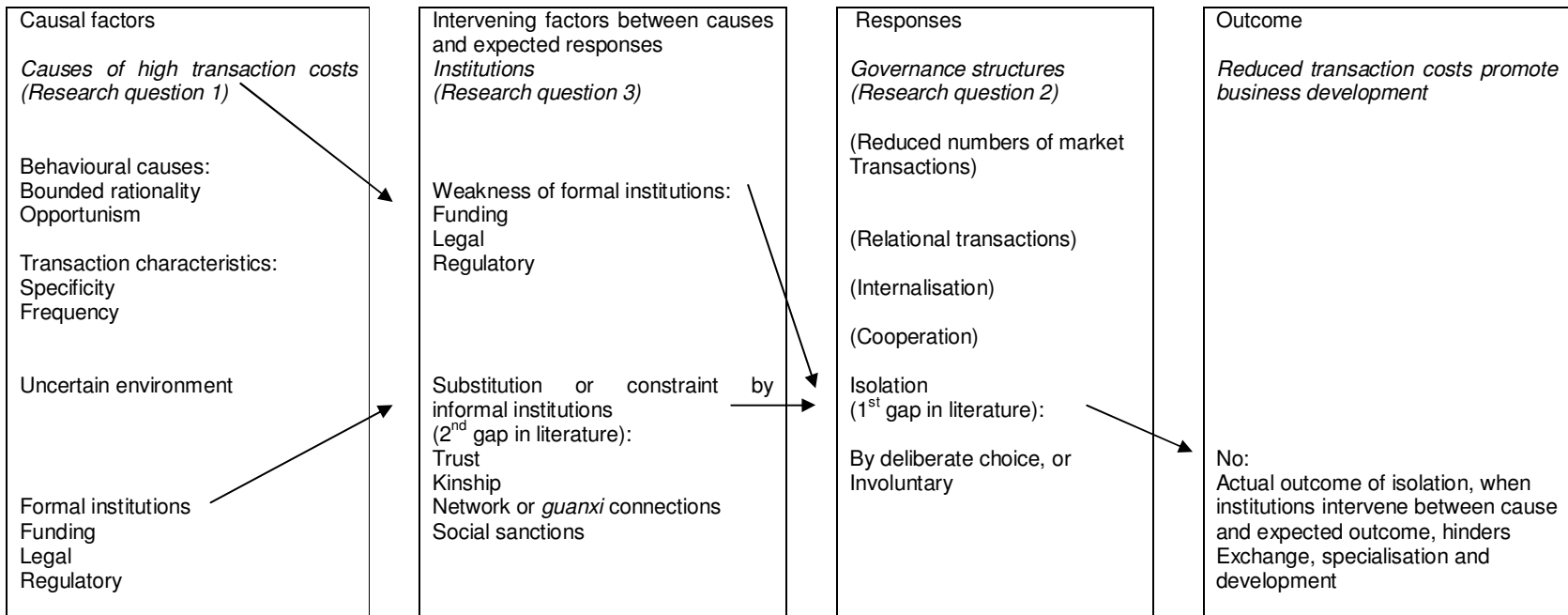


Figure 5 Flowchart 2 – Modified conceptualisation of causes of and responses to transaction costs, incorporating exploratory study and institutional literature

(Source: author)

CHAPTER 5 METHODS

This chapter presents the critical realist epistemology underlying this study, and it explains the qualitative approach taken to understanding perceptions of the causes of transaction costs, rather than quantification of absolute levels of costs. It introduces the fieldwork participants and the methods used in data collection and analysis; each of these sections closes with a description of how the methods were employed in this study. The chapter proceeds to describe the collection of qualitative data through unstructured interviews, with questions relating directly to the transaction cost and institutional literatures, and with supporting context interviews. The Qualitative Comparative Approach (QCA) is introduced, and its use explained for the analysis of the causal complexity involved in interpreting the interaction between transaction costs and institutions. The chapter closes with a review of ethical issues relating to data collection, whilst the evaluation of the study as a whole is presented in Chapter 9.

5.1 Methodology

5.1.1 The choice of a qualitative approach

Strong arguments have been made in support of qualitative approaches to international business research. These include a need for more theory generation than testing in the relatively immature discipline of international business, the potential of achieving greater cross-cultural understanding of the research phenomenon in context, a better fit with business practice in cases where research is conducted in developing-country contexts, and an ability to explore “why” and “how” in addition to quantifiable or observable behaviour (Marschan-Piekkari and Welch, 2004). In connection with the last point, “qualitative data [can] offer insight into complex

social processes that quantitative data cannot easily reveal” (Eisenhardt and Graebner, 2007: 26). In their study extending institutional theory, Greenwood and Suddaby (2006: 31) justify a qualitative approach for their “complex social setting in which causal dynamics were not immediately apparent”, which equates to this study’s critical realist concern for context and underlying causal processes (see section 5.1.3).

A qualitative approach is all the more relevant to the current study, as its research questions demand an understanding of participants’ perceptions of transaction costs, rather than a quantification of the costs. This approach can address the two key questions of perception and decision-making:

The crucial issue is the way that individual managers perceive, weigh and judge these [transaction] costs. Different managerial judgments determine different outcomes, and this explains, in part at least, the consistent differences observed between firms (Buckley and Chapman, 1998d: 77).

This perception of costs and risks cannot be ascertained through objective data, but rather is best explored through qualitative interviewing (Zhou and Poppo, 2008). Even if a transaction cost is not – or cannot be – measured, it has an effect when it influences the outcome of managerial decision-making. When the perceived transaction costs of alternative courses of action are compared in the process of making a decision, it is the perception of the cost, rather than the actual or quantified cost, that has driven the decision (Buckley and Chapman, 1998d). The principle of transaction cost minimisation does not assume “explicit transaction cost calculations”, so much as a comparison of relative transaction costs (Martinez and Dacin, 1999: 93). This is a comparison that can be achieved through qualitative comparison without the need to quantify costs: “It is the difference between rather than the absolute magnitude of transaction costs that matters” (Williamson, 1985:

22). Rao (2003) elaborates on the application of transaction cost theory explaining that in practice, economic decisions must be and can be made even in the absence of complete information regarding all relevant elements of cost – including transaction costs. Instead, decisions are based on the qualitative comparison of alternative institutions and governance structures. These decisions can be made, “as long as the managers know, or think that they know, the *relative* size of the quantities” (Buckley and Chapman, 1998b: 261, italics in original). This subjectivity of perception and decision-making leads back to the opening quotation’s mention of different outcomes between firms, showing that a qualitative comparison of outcomes needs to be made between firms by the researcher, as well as within firms by decision-makers. The qualitative approach will make knowledge-claims based on constructivist rather than positivist perspectives, using an ethnographic strategy of enquiry (Creswell, 2003) as will be discussed below.

The obvious alternative to a qualitative approach to transaction costs would be to quantify transaction costs, but the literature offers few suggestions as to how this could be attempted. The difficulty, or near impossibility, of measuring actual transaction costs is widely reported: from trying to quantify the potential for networks to reduce hard-to-measure transaction costs (McDonald and Vertova, 2002), to the impossibility of measuring all the valuable attributes of a good or service for sale, anticipating future income flows derived from it, and to what extent the flows might be affected by other parties (North, 1990). One conclusion is resonant with frustration: “Transaction costs... are often outside the domain of quantification altogether” (Buckley and Chapman, 1998d: 72).

As a substitute for quantifying actual transaction costs, quantitative estimates can be made. For example, the component parts of a transaction cost could be estimated, such as asset specificity broken down into the hypothetical income streams from the

assets, the opportunity cost of the use of the assets, and the cost of redeployment of the asset to a different customer-supplier relationship (Jones, 1997). Alternatively, proxies can be used. For example, the difference in house prices with and without telephone connections can be used as a proxy for the cost of the connection. This can further be split into the actual cost charged for such connections, and the remaining transaction cost element (Rao, 2003).

However, the literature also contains numerous warnings regarding the limited effectiveness or completeness of quantitative approaches to transaction costs.

Rao (2003) cautions that obtaining actual firm-level data for costs such as information search, monitoring and enforcement might come at a cost that exceeds the benefit of the study, and that in any event these would need to be supplemented with the estimated costs referred to above. Furthermore, the use of proxies may be limited by their inapplicability in different contexts – those designed in the West may not be comparable in emerging economies, requiring new proxies to be developed for each research context (Meyer and Peng, 2005). The present author questions whether the judgments regarding estimates and proxies would be more usefully made within the firm by managers (in their perception of transaction costs), than by outside researchers estimating non-quantifiable costs.

Even more critical to this study than the difficulty of quantifying transaction costs, is the fact that this would not answer the research questions. Our concern with the causes of and responses to transaction costs falls within the normative aspect of transaction cost economics, which concerns the gap between current or proposed practice and an optimal solution, rather than the positive aspect which addresses the magnitude of costs (Rao, 2003). Because of this, the approach must be qualitative rather than quantitative:

What matters, rather than computation of fully recognised transaction costs, are managerial perceptions of transaction costs. These perceptions are not expressed in numbers, but in language (Buckley and Chapman, 1998d: 57).

5.1.2 Ontology

Within the qualitative approach to this study, the theoretical stance incorporates both interpretive and realist ontological positions.

5.1.2.1 Interpretive strand

This study aims to understand the perceptions of and responses to transaction costs by the business proprietors participating in the research, and the knowledge it seeks is thus the reality that the participants construct from them. The research question cannot be answered simply by empirical observations of transaction costs without reference to the meaning they hold for the individual participants and the consequent effects on their decisions. The researcher shares the view that:

It is necessary to explore the subjective meanings motivating people's actions in order to be able to understand these... [the] role of the interpretivist is to seek to understand the subjective reality of those that they study in order to be able to make sense of and understand their motives, actions and intentions in a way that is meaningful for these research participants (Saunders et al., 2003: 84).

A positivist ontology would not be appropriate to this study. It would necessitate a controlled experiment for the objective measurement of observable realities (Phillimore and Goodson, 2004), where in fact we seek to understand subjective influences on individual behaviour. In the context of economic research, this is equivalent to moderating a positivistic assumption of perfect information, with an anticipation of the individual's bounded rationality: whether this rationality is understood as being a partial or limited portion of the economists' higher-level

perfect information, or a more anthropological view of knowledge built up from scratch, transaction cost economics requires an ontological position that accommodates the individual's interpretation of reality (Buckley and Chapman, 1998a).

The emphasis of this study on the subjective influences of individual perceptions and motivations is already established in the field of enterprise research, which accepts and explores each entrepreneur's own perception and interpretation of the world (McAuley, 2007). This explains our wish to interpret the participating business proprietors' own responses to the transaction costs and institutional constraints they perceive in their environment, rather than simply assuming that all participants would both perceive and respond to these factors in the same manner. An interpretive approach to enterprise research is also more pertinent than positivism, to the aim of theory-building in a young field rather than hypothesis-testing in a mature field rich in theory (Hine and Carson, 2007). The interpretive approach has further been recommended for the study of rural development (Ellis and Biggs, 2001), informal institutions (North, 2003), tourism in general (Peterson, 1994), and tourism in China (Xiao and Smith, 2006), all of which are important to the context of this study.

5.1.2.2 Realist strand

Whilst the focus of this study is on participants' own perceptions, some of their interpretations may be shared if they are based on stimuli that are experienced in common (Saunders et al., 2003). This suggests a reality that exists independently of human thoughts, but which contributes to the individual's interpretation of their environment or to their construction of the meaning of their environment (Creswell, 2003). Knowledge of this reality is therefore interpreted, and is theory-laden rather than objective: "Social phenomena such as actions, text and institutions are concept-dependent" (Sayer, 1992: 5). This study therefore needs to acknowledge the external,

objective, macro aspects of society, but to explore them in terms of the individual's interpretations. Where realism explores the influences or constraints on individual choices by broader social forces or structures, this will be applied in terms of the constraints on participants' responses to transaction costs imposed by the external institutional context.

Critical realism draws together the two ontological strands of interpretivism and realism, claiming that although reality has an objective existence (the realist strand), our knowledge of it is mediated through concepts (the interpretive strand), with the resulting conclusion that: "facts are *theory-dependent* but they are not *theory-determined*" (Danermark et al., 2002: 15, italics in original). This mediation of knowledge by theory is illustrated in the context of tourism research, by the observation that the information presented in publicity materials is conditioned by – and is not independent of – the culture within which it is generated (Tribe, 2004).

5.1.3 Critical realist epistemology

Danermark et al. (2002) argue that conceptualisation in social science should be rooted "in a critical realist ontology and epistemology" – reality is socially defined and produced, and our knowledge of it is gained through interpretation. The sequential interpretation, first of reality by social actors, then of actors' reports by researchers, is described as "double hermeneutics" (Danermark et al., 2002: 32). Critical realist research seeks out actors whose "voices are not usually heard" in international business research (Sharpe, 2004: 320). Prior qualitative studies have achieved this by representing the concerns of shop-floor workers in the UK subsidiary of a Japanese manufacturing multinational (Sharpe, 2004), and by reporting from the perspective of the local customers, suppliers, competitors and employees of a foreign firm entering China (Hansen, 2008).

Critical realism is concerned with three domains of reality: the actual (events that are independent of people's experience), the empirical (experienced or interpreted) and the real (containing generative mechanisms causing events to occur) (Bhaskar, 1975). The methodological implications of seeking to understand these domains are drawn out by Sharpe (2004): the account given by the agent or research participant, which would be the sole subject of a hermeneutic ethnography, are further interpreted by the critical realist ethnographer in the light of external social structures. The actual structures, when experienced by actors, enable or constrain their action: the contribution of the critical realist ethnography is thus to explain the effects on human agency of external structures, the interactions between micro-level practices and macro-institutional structures. Sharpe further explains how underlying mechanisms can be identified by the comparison between cases, for example where different results are not explained by differences in the causal conditions or structures experienced. The critical realist conception of complex and contingent causality is not concerned only with a cause leading to an effect, but also with negative cases where the cause does not lead to the effect (Danermark et al., 2002). Critical realist enquiry into causal mechanisms is better served by an intensive research design, with an in-depth, qualitative study of individual participants in context, rather than large-n surveys that seek regularity of events (Welch et al., 2009).

Following on from this anticipated interaction between the research participant and the context, the critical realist may consider firms to be embedded in their social context (Sharpe, 2004). This offers a clear parallel with Granovetter's (1985) view that economic behaviour and transactions are embedded in interpersonal relationships, and that human action can be both enabled and constrained by social structures. The realist position is that "state unobservable" constructs (such as opportunism) can be incorporated into theories (such as transaction cost theory) that

give us knowledge and can be used to derive normative rules to guide managerial action; qualitative methods such as ethnographic enquiries are an effective way of observing the impact on business of that which is otherwise unobservable (Godfrey and Hill, 1995).

This study will seek to apply a critical realist epistemology by exploring both the external institutional context – through documentary sources and through context interviews (see section 5.2.3) – and its effects on the research participants through their interpretation of it. The actors invited to participate in this study, proprietors of small firms in rural Western China, had not previously been involved in research – neither in the disciplines of Business nor Chinese Studies, with overseas or local researchers. Sharpe’s recommendation of comparing conditions and outcomes will be conducted using the Qualitative Comparative Approach (QCA), with the aim of exploring the possible mechanism by which institutions mediate between perceived transaction costs and participants’ responses to them. The negative cases will also be addressed by the qualitative comparison that explores causal conditions associated both with the outcome, and with the absence of the outcome, as causal symmetry is not assumed (Ragin, 2005b). As Granovetter’s work is central to this author’s integration of the transaction cost and institutional theories (see Chapter 4), we consider critical realism to be an appropriate perspective from which to explore the mediation by institutions between the causes of transaction costs and firms’ responses to them – linking the micro level of transaction cost explanations of economic behaviour with the macro level of institutional constraints (Madureira, 2007).

5.1.4 Strategy of enquiry

The preferred strategy of enquiry for this study would be a critical realist ethnography, but for reasons that will be explained below, the study borrowed some

elements of the technique in a more limited application. This strategy enables the exploration of the influence of structures on the agency of individual firms:

Critical realist ethnography provides a means of examining and theorising about the connections between micro-practices and macro-structures, and between changes in micro-practices and changes in macro-institutional structures (Sharpe, 2004: 309).

Ethnographic methods are particularly supported in the research of firms, for exploring the reasons behind firms' economic behaviour and providing "real, basic, well-founded knowledge about what companies do, and why they do it" (Chapman et al., 2004: 303). Sharpe (2004: 306) explains that by seeking to understand this behavioural process an ethnographic approach allows the researcher to avoid an assumption of rational economic behaviour, and such an approach – with critical realist foundations – "recognises the social embeddedness of rationality, that is, rationality is always context-dependent". In the context of international business research, transaction cost economics is identified as a theory well-suited to bridging between the disciplines of economics and social anthropology (Buckley, 1998).

An ethnographic enquiry would typically be characterised by participant or non-participant observation and questioning during long-term immersion in the site (Robson, 2002), and use of the local language (Buckley and Chapman, 1998e). Participant-observation in business research normally entails employment in the firm studied, as a means of participating in the events observed – for examples see the ethnographies set in a Swiss investment bank (Bruegger and Knorr-Cetina, 2002) or a Japanese advertising firm (Moeran, 2005).

An approach incorporating employment was impossible in the current study, due to the restricted conditions under which work permits are issued to foreign citizens in China, and to the very small number of outsiders employed by the firms under study. Participation would also risk losing the sharp focus of the research questions,

compromising the ability to compare multiple firms, and diverting employment away from locals. Furthermore, the duration of the field study was belatedly curtailed by the visa restrictions enforced by the Chinese government during the period before and during the Beijing Olympics, when long-stay visas were made unavailable. Given these constraints on participation and duration, but already equipped with the requisite language skills and access to participants, the author chose to work as a known researcher conducting non-participant observation (Lofland and Lofland, 1995) and unstructured interviews (Bryman, 2008), pursuing the original aim of exploring participants' subjective, constructed meanings (Creswell, 2003). Whilst the duration of individual site visits was constrained by visa restrictions, the author visited the site three times over three years. This extended engagement with the site enabled the researcher to fully understand the environment and restrictions it places on the participants, and to gain the confidence of participants such that sensitive questions could ultimately be addressed.

The correspondence between interview-based data collection and a critical realist stance appears to be confirmed by Madureira (2007): "A critical realist explanation is typically inferred from the *accounts of individuals* under the assumption that many causes are ordinary and fairly well understood by actors" (p16, emphasis added). In addition, the field of business research offers work presented as ethnographic or anthropological studies, where data were collected by means of workplace interviews and some observation – see, for example, an ethnography of 38 family firms in Italy (Yanagisako, 2002), cooperative strategies in 19 European firms (Buckley and Chapman, 1998c), economic and social ties in 23 American clothing firms (Uzzi, 1997) and the development of e-commerce in nine organisations (Graham et al., 1996). To support the collection of rich, qualitative data for this study, the author considers interviews to be a more effective research instrument than surveys, because of the opportunity to build a rapport with a small number of participants for the

collection of richer interpretations, and for its applicability to theory-building (Daniels and Cannice, 2004). For research in China, postal delivery of surveys may be uncertain, and respondents frequently select “don’t know” as a response (Zweig and Fung, 2007); and personal visits to Chinese research sites are strongly recommended over surveys, to increase the researcher’s understanding of local issues (Eckhardt, 2004). In a recent study of transaction costs in Beijing and Shanghai, the questionnaire was administered within a workplace interview, suggesting that face-to-face contact is more effective in this context and for this topic (Zhou and Poppo, 2008).

In summary the author has borrowed elements of ethnographic technique, and whilst heeding Wolcott’s advice to avoid describing the output as “an ethnography” (1999: 220), believes that the method has achieved its purpose:

The overall aim of an ethnographic approach to small business research would, therefore, be to produce a descriptive and ‘explanatory’ analysis of the historical, situational biographically mediated interpretations offered by entrepreneurs and small business owners of their economic involvement and its significance for themselves and the wider society (Curran and Burrows, 1987: 10).

5.1.5 Abductive inference

Abductive reasoning makes inferences from specific interview data, to a more general development of theory (Danermark et al., 2002). Critical realist abduction considers individual phenomena to be manifestations of underlying structures or processes that are not actually present in the empirical data. For example, the researcher might observe a behaviour and interpret it as part of a normative structure, or as a response constrained by another process. This is achieved by redescription or recontextualisation, whereby the observations are interpreted in a new contextual framework. The possibility of choosing different frames of interpretation leads to the

potential for different conclusions to be drawn from an interplay between cases and theory (Blaikie, 2000). This means that, although the aim of abduction is to generate new insights, the conclusions will be fallible and should not be considered as proof of how things must be.

Abduction will be employed in this study to refine the general theory of transaction costs, by making inferences from the participants' perceptions of transaction costs in the new framework of institutional constraints. The interplay between cases and theory will be performed using QCA, which will be described fully in section 5.3.3. This study will seek new insights by describing connections that are not directly observable, to offer a new meaning to the phenomena of firms' behaviour that are already known.

5.2 Research design: data collection

The field study drew on site visits made by the author over a period of three years, which began with elements of observation, familiarisation and informal discussion, and culminated in the principal data collection exercise of 2008. This used unstructured interviews with the 13 participating firms.

5.2.1 Data sources for principal field study

5.2.1.1 Level and unit of analysis

The research questions concern the perceptions of and responses to transaction costs by decision-makers in the participating firms, so it is logical that the analysis for this study should be at the micro-level of the firm. The firm is recommended as the appropriate level for transaction cost analyses (Douma and Schreuder, 2008), and has been used in empirical research into the impact of institutional context on firms'

decisions and development (Locke, 1996) and into the strategies and developmental impacts of hotels in developing countries (Fortanier et al., 2006).

Although the firm was considered to be the analytical unit, the observational units were the decision-makers in the participating firms who were interviewed for their perceptions of transaction costs affecting their firms (Douma and Schreuder, 2008).

5.2.1.2 Selection of site, firms and participants

The selection of the field site, the tourist destination of the Tiger Leaping Gorge in Northwest Yunnan Province, was justified in Chapter 1 on both theoretical and practical grounds.

A relatively small and self-contained area was delimited for the study, to aid clarity of observation and explanation in a similar vein to Ostrom's selection of sites for understanding collective action:

Scientific strategy frequently has involved identifying for empirical observation the simplest possible organism in which a process occurs in a clarified, or even exaggerated, form. The organism is not chosen because it is representative of all organisms. Rather, the organism is chosen because particular processes can be studied more effectively using this organism than using another... Because these [her field-sites] are relatively small-scale situations, serious study is more likely to penetrate the surface complexity to identify underlying similarities and processes (Ostrom, 1990: 26).

A screening profile was applied in this area to identify the population of firms for the study, to enable “meaningful and insightful comparisons” between participants (Bechhofer and Paterson, 2000: 2). It sought firms providing services to inbound tourists; privately owned *getixing* enterprises (not collective or state-owned, run by one or more households, with up to eight employees – Peng, 2004), and not part of a branded chain. Ownership was not restricted to local residents (whether in terms of

county, province or country), or to businesses that were formally registered. In the absence of a formal sampling frame, which is a common problem in studies of small firms (Freel and Harrison, 2006) and of the tourism sector (Novelli et al., 2006), the screening profile was applied to all firms in the specified area. The risk of omitting firms that were absent from databases or registers (Capelleras et al., 2007) was avoided by the author's physical exploration of the area, to identify all tourist enterprises which, by their nature, were openly advertising for clients.

It was intended that the principal interview participants should be those who represented themselves as decision-makers in the case firms, accepting that in China, opacity of ownership presents difficulty in distinguishing between owners, managers and employees with responsibility. Supporting informants within participating firms were sought to give a richer understanding of each firm (Coviello and Jones, 2004).

5.2.1.3 Resulting participant population

The screening profile identified 14 suitable firms as comprising the accessible population (Ghauri, 2004), from a total population of 16. All 14 were formally registered as *getixing* enterprises, and were family-owned. All offered services such as accommodation, food or guiding to inbound tourists in the specified geographic area. All 14 firms are described below, including the 13 who participated in the complete data collection exercise. One firm withdrew part-way through but made interesting comments before withdrawing, which will be attributed to "the non-participating interviewee" in the remainder of this study. The firms are not identified at this stage, to avoid connecting their descriptions to the subsequent analysis. From Chapter 6 they will be referred to as P_n (with numbers allocated in a different sequence to their descriptions below), to structure the analysis whilst preserving their anonymity.

Qiaotou guesthouse

The founders of this firm are a Tibetan family, who moved from Zhongdian to the market town of Qiaotou in 1999 to set up a tourist café, which they expanded into a guesthouse in 2003. It now employs three family members and two staff. It offers meals and accommodation for about 20 guests, and bag storage for non-resident tour groups; it competes intensely with Qiaotou's other tourism firm. The site of Qiaotou offers the most comprehensive road transport and communications (landline, mobile phone and email) infrastructure, and the large market is vital to this non-farming enterprise.

The proprietor's long-term aim is to generate surplus revenue, by attracting more guests with en-suite rooms – but these would be funded through future retained profits, and no timescale was specified. The slower trade in 2008 was explained by a well-informed list of causes including the Olympic visa restrictions, the Sichuan earthquake, the Tibetan protests, floods and the winter travel disruption. The business appears to be mature but not growing, and is focused on the proprietor's English skills.

Qiaotou café

This is a café and guiding operation in Qiaotou, established in 2001 by an expatriate who had worked for another participating firm since 1994. The proprietor chooses to work alone, rather than employ an assistant. The café's prominent location assures a strong passing trade, in addition to bookings routinely made by phone, email and via international tour operators. All supplies are bought in.

The aim of the mature and stable business is to provide a livelihood to the proprietor, and to contribute to local development by attracting tourists; there are no plans for expansion. During 2008 the proprietor had written to the author about the disastrous outlook for local tourism, but by September (when the data collection took place) she believed that numbers were beginning to recover and that competition had not eased.

Pony trekking

In 1998, this Naxi farming family began to take in guests, extending their farmhouse in stages to accommodate the growing guesthouse (that now has 50 beds), shop and pony-trekking business. It employs the immediate family – although the three children are in higher education and so are often away from home – and one member of staff, with two more to be recruited soon. It is sited on the main tourist path, is the first guesthouse reached from Qiaotou, and has dry-weather vehicle access. Good communications include international landline, mobile phone and internet.

The guesthouse provides a comfortable family life and extensive local employment; farming is a secondary activity. The most recent extension to the buildings was completed in 2008, but there are no plans for further extensions as the proprietor wishes to enjoy a period of peaceful stability. He claims not to know why guest numbers were lower for 2008. The business is mature and taking a deliberate, rather than forced, step back from investment and growth.

Naxi farmhouse

This is another Naxi farmhouse, which has been expanding since 2001 to its current capacity of 65 guests. It offers accommodation, food and a shop, and employs four members of the extended family. It is also on the main tourist path with dry-weather vehicle access. There is

mobile phone communication, but the proprietor does not expect ever to be connected by landline or internet.

The aim is to continually increase guest numbers and reduce reliance on farming, to be achieved by attention to customer service. The planning horizon is one year, the longest of all the guesthouses. Guest numbers were low in the first half of 2008 for understood reasons, but the resilient business had already recovered by September. It is mature, had extended within five years of establishment in direct contrast to the two that will be described next, and is still growing.

Tibetan farmhouse

This small working farm has offered very basic accommodation and home-grown food for five guests since 2003. It provides part-time employment to the two owners, Tibetans from Zhongdian, whose two children are in full-time education. The site is distant from the main tourist path and a quarter of a mile from a rough vehicle track; there is mains electricity and communication by mobile phone.

The aim of the guesthouse is to supplement the family's income from farming and casual portering, despite the recognised disadvantage of location and insufficient funds to upgrade the facilities. The proprietor proposes to overcome the problems of remoteness and lack of publicity by walking two hours to Qiaotou to recruit guests – and recognises the implied cost of potentially wasted journeys. He is unsure why trade this year has been so much worse than in earlier years. The business is still in its infancy after five years.

Solo farmhouse

This is another five-year old guesthouse on a working farm, run single-handedly by a local Naxi lady to offer food and accommodation to a dozen guests. It has always been in direct competition with its larger neighbour, within sight a mile away, but suffers from being located on a more minor branch of the tourist path. There is landline and mobile phone communication, and access via a steep vehicle track.

The purpose of the guesthouse is to supplement farming income, but the proprietor is too busy running the farm and the guesthouse to make active efforts to seek new customers. Future development would consist of building more rooms if guest numbers demanded it, which at present they do not. The proprietor is aware that the Olympics, earthquake and Tibetan protests have greatly reduced visitor numbers this year. This business has also failed to enter a growth phase, suffering from a shortage of publicity and staff.

Han farmhouse

A Han farmhouse that has been gradually extended to 90 beds, since first offering shelter to lost trekkers in 1992. It offers meals and accommodation, and employs two family members and four staff. There used to be more locals employed as guides on Haba Mountain, but environmental degradation caused by mining operations had halted this before the author's first visit in 2007. The proprietor considers all other guesthouses to be competitors. Again, this is on the main tourist path with weather-dependent vehicle access, and communication is only by mobile phone.

The guesthouse is intended to fund the education and future overseas travel of the proprietor's three children, by means of efficient and diligent work, and attracting guests with upgraded facilities. In 2007 the proprietor told the author that he expected his business to peak in the Olympic year of 2008 and then decline; by September 2008 he conceded that

the decline had already started. The business has passed its peak, but the proprietor is still investing in an attempt to maintain its competitiveness.

Junction guesthouse

This 150-bed guesthouse stands on the site of the original Han farmhouse, which began to offer accommodation in 1997. It is located at the junction of the tourist path and the all-weather road back to Qiaotou or onward to the villages of Walnut Garden and Haba. It employs eight staff providing accommodation, meals and a shop, and also arranges taxis to Qiaotou, a daily scheduled bus to Lijiang, and guided walks down a privately-maintained path to the river. There is mobile phone but no internet.

The proprietor hopes to attract increasing numbers of guests, but feels unable to make plans for an uncertain future. She does not expect to add any more buildings to the newest ones finished in 2004. This guesthouse adapted to the decline in foreign tourists by marketing itself also to domestic tourists arriving by car, and as a result the business is stable.

The next two guesthouses are located on the road close to this one, but have been unable to compete against it.

River path guesthouse

This guesthouse opened in 2005, when the Han farming family began to add purpose-built extensions. There is now accommodation for 25 guests, dining, a privately-maintained path to the river, and a shop that also serves as a taxi-rank. It employs four family members. Communication is by mobile phone, and by reportedly slow wireless internet.

Again, the intention is to raise supplementary income, but guest numbers had already peaked within three years of opening. The business appears to be in an early stage of decline, with no funds available for investment but with a well-stocked shop and restaurant.

Struggling guesthouse

This Naxi farming family opened their guesthouse in 2001, which sleeps 20 and employs three members of the immediate family. Communication is by mobile phone only.

The guesthouse is intended to supplement the family's income from farming. The proprietor would like to transition to the guesthouse as the main source of income, supplemented by farming, but does not expect guest numbers to rise before they undertake extensive building renovations, for which increased revenues are a prerequisite. In 2007 a family member told the author that the business was struggling: this was a year before the events of 2008 began to depress other, healthier businesses. The author was the only guest during the 2008 National Day holiday, a peak period when most other guesthouses were close to capacity.

The next three firms are all in Walnut Garden, a village on the gorge-road between Qiaotou and Haba.

Oldest guesthouse

This Bai family began to take in passing foreign trekkers in 1980, and in 1983 set up simple accommodation to offer them. It now has accommodation for 40 guests, offers meals and a taxi service, and employs three immediate family members and a few casual staff. Communication is by mobile phone, but the proprietor expected the installation of a landline and internet connection in 2009.

The business grew steadily until 1997 when the surfaced road through the gorge was completed and trekkers began to travel back to Qiaotou direct from the end of the path, heralding a reduction in guest numbers. The family has responded to this decline by upgrading (rather than extending, as per their earlier plans as described to the author in 2007) the guesthouse facilities and seeking two alternative incomes from driving. They recognise the opportunity cost of farming, and gave it up in 1997 because the higher returns from driving or managing the guesthouse outweighed the cost of buying all food supplies in from Qiaotou. The business is mature, but has largely stopped developing as the proprietor focuses increasingly on alternative livelihood strategies.

Teacher's guesthouse

This Han-Tibetan farming family first opened accommodation for 16 guests in 2006, and three members of the immediate family are employed in the guesthouse and shop. Communication is currently by mobile phone, but they expect to acquire a landline and internet connection soon.

The guesthouse is intended to further diversify the family's livelihood that currently spans farming, driving and teaching. The proprietor plans to convert an old building into en-suite guest rooms, indicating that the business is coping in the current downturn. The business began growing soon after its establishment, when an international tour operator chose it as a regular stop.

Tour guide

This Tibetan family opened its guesthouse in Walnut Garden in 1982, and has been extending it ever since. It now sleeps 80, offers meals and wireless internet, and the proprietor conducts tours both independently and on behalf of tour operators. It employs five members of his extended family.

Like the interviewees in Qiaotou, the proprietor is an English-speaker focusing exclusively on his tourism business. The return he earns from tourism is high enough that he has even sold his fields, and he intends to recruit more staff when the current construction of extensions to the buildings is complete.

Haba guesthouse

The village of Haba is at the opposite end of the gorge from Qiaotou. This specialist guesthouse was established in Haba in 1986 by a Naxi farming family, and now sleeps 30, offers meals and cultural walking tours of the surrounding villages, and equips and escorts mountaineering expeditions to the summit of Haba Mountain. It employs four family members, and also numerous local guides and horsemen on demand. Infrastructure provision is recent: the first road to Haba was built in 1993 and surfaced in 1998, and mains electricity replaced the household's own hydropower generation in 2007. There is communication by both landline and mobile phone.

The guesthouse is the family's sole source of income, supporting two children in higher education and allowing the family to contract out their farm work. It has grown constantly since 1998, and guest numbers even rose during the Olympic year – the proprietor was aware that this had damaged tourism elsewhere. If guest numbers continue to rise, the proprietor will respond by adding more rooms.

The relatively small number of participants has not been considered to be problematic, as it allowed for the collection of rich data from every participant, with the researcher focusing on depth rather than breadth (Daniels and Cannice, 2004). Moreover, the number of firms was small enough for the researcher to interview them all, so there was no need for a sampling strategy (Fletcher and Plakoyiannaki, 2009). The number of cases fell within the recommended range for enterprise research of four to 15 (Stokes and Perry, 2007), and Chapter 6 will show that this was sufficient to demonstrate variation before the point of theoretical saturation was reached (Eisenhardt, 1989).

The number of interviewees within each participating firm was limited, because all are still owned and managed by the original founder. This is characteristic of Chinese private enterprise (Poutziouris et al., 2002), which was first allowed in China after economic reforms were initiated in 1978. The scarcity of supporting informants increased the researcher's dependence on context interviews in the evaluation of the interview data, which is a recognised feature of research into small, and especially Asian, firms (Stokes and Perry, 2007).

5.2.2 Fieldwork method

5.2.2.1 Discussion topics

A series of nearly 100 generative topics was prepared, making a direct link from the research questions and concepts, through the specific references in the literature (as presented in Chapters 2 and 4), to the topics to be addressed during the interviews. The connection from the literature to the topics is illustrated next with the example of opportunism, and a tabulated summary of all of the links from research questions through references to interviews is presented in Appendix 1; this further adds the codes that were subsequently employed for data analysis.

The interview topics prompted discussion of whether the participant perceived the presence of each individual cause of transaction costs, his perception of levels of institutional protection or constraint, and his decisions regarding the structure of their firm and relationships with other firms. For example, the transaction costs caused by opportunism were discussed in terms of types of opportunist behaviour (with source references including Buckley and Chapman (1998a), Wathne and Heide (2000) and Williamson (1985)), participants' perceived risk of being cheated (Williamson, 1985), how the participant would judge a stranger's propensity to cheat (Douma and Schreuder, 2008), and his likely response to it (Zhou and Poppo, 2008).

The first of these, concerning types of opportunist behaviour, was operationalised as three interview topics. In the first, the author explained her wish to discuss a behaviour that the participant might have observed, that could be described as opportunism, unfairness, or taking advantage of others – the aim being to clearly communicate the intended topic of conversation, but without pre-empting the participant's responses. The author then asked the participant whether they had ever experienced such behaviour, and to give examples of types and actors carrying out or suffering from such behaviour. The remaining two topics were designed as prompts, to help to elicit detail if participants were to struggle with the question. The second topic included examples of lawful opportunism, and the third was blatant opportunism; both were examples drawn from the literature, of very specific ways in which opportunists might behave.

Chapter 6 will explain in detail how each participant's responses were coded, using the illustrative example of the set of case firms with an awareness of types of opportunist behaviour occurring in the research environment. In the table in Appendix 1, this appears as fuzzy set code TOL1, and actors performing or suffering from opportunism are coded in sets TOL2-TOL5. The interview topics were coded as

82 fuzzy sets, and ultimately analysed as six causal conditions; the much larger number of topics demonstrates the author's attempt to offer multiple ways of thinking about individual concepts, to ensure the participants' full understanding. Their responses could therefore be distilled into far fewer items.

5.2.2.2 Interview technique

The participants were engaged in unstructured interviews using open questions (de Geer et al., 2004), in which the style of questioning was informal, the phrasing and sequencing of questions varied to suit the needs of each participant, and which allowed the researcher flexibility to clarify responses or pursue emergent issues (Bryman, 2008). The questioning was based on an interview guide, which listed the topics described above as an aide-mémoire for the researcher and included translations of key terms, presented both in Pinyin (romanised Chinese, for the researcher's convenience) and Chinese characters (for interested participants). The topics on the guide were numbered to facilitate structured note-taking and cross-referencing by the researcher, but the numbering did not dictate the sequence in which the topics were raised in the interviews. The only general pattern to sequencing was that company background was addressed first, to inform subsequent questioning, and the topics regarding outcomes were addressed before those on transaction costs, to avoid the participants offering outcomes that they thought the researcher sought. The table in Appendix 1 presents indicative interview questions based on the interview guide.

Questioning was generally in direct form: although the author had earlier considered the use of native categories (Harris, 2000), this was abandoned prior to the principal data collection exercise in an attempt to maximise the clarity of expression in conversations crossing language barriers. However, the style of questioning was indirect when the topic under discussion concerned behaviours that the participants

might consider negatively. In the style of a recent qualitative study on corruption (Antoniou and Chapman, 2009), participants were asked about opportunism, cheating or leverage of *guanxi* as practised by other people rather than by themselves. The author was also aware from prior experience – in this and other Chinese sites – of the importance of avoiding leading questions, and so took great care not to direct participants in prompting them for fuller details or opinions (Bryman, 2008).

Observation was used to supplement the interview data (Hansen, 2008), and also to serve for triangulation of participants' reports. This is recommended for qualitative research in China where participants may be unaccustomed to articulating their feelings, and participant observation would be difficult to arrange (Eckhardt, 2004).

The author wrote fieldnotes by hand during the interviews and typed them up as soon as possible afterwards; notes were made in the researcher's native English for speed (Yanagisako, 2002), but with key terms being noted in the interview language to preserve the speaker's original expression. The numbering of questions made it easy to generate structured notes from the unstructured interviews, without the need to transport pre-printed answer sheets (Lapsley, 2004). Although qualitative fieldnotes are bound to contain some of the researcher's interpretation (Miles and Huberman, 1994), the author maintained a distinction between the participant responses and her personal impressions that formed an integral part of the fieldnotes (Sanjek, 1990).

5.2.2.3 Choice of language

The choice of language in which to conduct interviews is an important methodological consideration, going beyond personal preference to a reflexive consideration "of power affecting the dynamics of the interview situation" (Marschan-Piekkari and Reis, 2004: 227). They recommend that, where linguistic

equality cannot be achieved because parties to an interview do not share a native language, the language used should be chosen to the advantage of the research participant. Two participants in this study, one of whom was a native speaker of English, nominated to have their interviews conducted in English. The non-participating interviewee also chose to converse with the author in English, which enabled him to freely criticise the government without apparent fear of being overheard by his staff.

Five of the remaining eleven participants were native speakers of Mandarin Chinese, giving them a linguistic advantage over the researcher whose native language is English. The other six participants were members of the Naxi and Tibetan ethnic minorities, for whom Mandarin is not native but is necessary in education and business, and they spoke only elementary English; the search for a common language was therefore restricted to the non-native Mandarin of both researcher and participants. In these cases, speaking Mandarin offered a mutual linguistic challenge to participant and researcher alike, which is preferable to the researcher taking the linguistic advantage. This mutual challenge can negatively impact the communication between participant and researcher (Chapman et al., 2004), or alternatively can encourage the speakers to use simpler expressions and so achieve clearer and more direct communication (Ghauri, 2004). The author found the latter to be the case: the researcher was forced to avoid specialist terms, and the responses were given in slower and plainer Mandarin than native speakers would have used. Furthermore, the author had observed a tendency of some Han Chinese tourists, as native speakers of Mandarin, to condescend to their minority hosts: the author was keen to avoid repeating this.

However, construct bias can be a risk in crossing languages and cultures (Marschan-Piekkari and Welch, 2004). This was resolved by pursuing the ideas in non-technical

terms, as is common in research with management practitioners as participants (Buckley and Chapman, 1998d). This applied particularly in the cases of the concepts of information asymmetry, where responses to open-ended questions indicated an incomplete understanding, and of opportunism which was understood very differently by participants and merited further investigation rather than treatment as a translation error (Chapman et al., 2004).

On the other hand, the researcher's being non-native had its advantages (Wilson, 2004): sensitive questions could be posed in the guise of language clarification or of naïveté, and pursued despite non-verbal, culture-dependent warning signals. Many participants also appeared to feel comfortable discussing political topics in Chinese without fear of repercussions, since the author was clearly not related to national or local government. This also helps to explain why the author chose not to work with an interpreter, as the benefit of linguistic clarity might have entailed the sacrifice of the author's non-native advantages by introducing a local third party (Marschan-Piekkari and Reis, 2004).

If a researcher in this context were to use English only, their pool of potential respondents and therefore findings would have been so restricted as to compromise the validity of their research (Wright, 2004). Therefore despite the difficulty of preparing to conduct unstructured interviews in a foreign language (Marschan-Piekkari and Reis, 2004), the author agrees with the view of Chapman et al. (2004) that local language is of primary importance to international business studies, and that the viability of a research project is determined by the language skills of the researcher.

5.2.2.4 Contextualisation of method

Michailova (2004) describes aspects of conducting empirical research in Eastern Europe, highlighting issues that are not anticipated by the mainstream methods literature written in and about the West. Some aspects require considerable adaptation to the research context, as described below, whilst others – the use of personal networks to secure interviews, lack of company registers, difficulty of planning meetings – simply require flexibility on the part of the researcher, as practised during this field study.

The author avoided dependence on written materials during the interviews. These might include interview reports for validation by research participants (Silverman, 2005), but this practice becomes inapplicable in a setting where participants' time and inclination to engage with the research ceases with the end of the interview (Michailova, 2004), or where low levels of literacy would then become grounds for deselection of potential participants.

Making audio recordings of interviews is recommended for increased reliability of results (Peräkylä, 2004), and to enable detailed analysis of how things were said without diverting the researcher's attention to note-taking during the interview. However, the author had been advised by Chinese and British academics who conduct research in China, supported by Xin and Pearce (1996), that making audio recordings of interviews would be culturally inappropriate here. It also seems likely that participants would have been less frank in their reports of the business and political environment if their comments were being recorded (Daniels and Cannice, 2004). On a practical note, many of the interviews were conducted in public areas of the guesthouses, so background noise would have reduced the quality of the recordings. Consequently, the data collected is the author's account of what was said and observed, based on her handwritten fieldnotes (Yanagisako, 2002).

A researcher might contemplate relaxing the ethical standards prevalent in Western research, if they considered these to impede the research out of proportion to the context. For example, Michailova (2004) reports telling participants that interviews would be recorded rather than asking their permission, and the current author chose, on occasion, to continue despite non-verbal cues signalling participants' discomfort with the line of questioning. The cues were noted to identify topics requiring closer attention during the data analysis.

Opportunities for the independent collection of primary, qualitative data by foreign researchers in China are recognised as being very limited (Quer et al., 2006). The author therefore considers these adaptations to have been worthwhile in facilitating her collection of a rare dataset.

5.2.2.5 Negotiation of access

An informal and contact-based approach to field access has been recommended by Michailova (2004) in emerging markets in general, and specifically for China by the author's academic advisors. As such, the first approach to potential participants in the principal data collection exercise of 2008 took the form of an informal conversation, with the author introducing the purpose of her research, and checking the screening profile. They were then invited to participate, given an estimate of the time commitment, and reassured as to the research ethics of confidentiality. The author was already known to several of the participants prior to this, following an informal visit to the site in 2006 and the exploratory field study in 2007, so in some instances a rapport was already present between researcher and participant. This existing rapport coincides with the advice of Lofland and Lofland (1995: 19) of "starting where you are": choosing a research site in which you have an interest and where you are already established, so that access should be more straightforward to arrange than would be the case for an unconnected researcher. It was to prove

especially valuable given the time constraints imposed on the 2008 collection exercise, when tightened visa restrictions curtailed the intended study period.

Despite this rapport, the author's role was as an "outside", or non-participating, observer (Lofland and Lofland, 1995). As such an outside researcher, close access to the participants could have been made problematic by differences such as nationality, age and gender. In the event, the nature of the participating firms – guesthouses targeting foreign visitors – made them react positively to the foreign researcher's initial approach. The first individual with whom the female researcher came into contact was almost always female, often of a similar age, and so conversation was not hindered by social constraints. The Caucasian researcher was clearly of a different nationality, but this served usually to prompt questions from the participant about how families, farmers or even teenage girls live in the West, rather than causing them to guard their responses.

The author therefore presented herself as an outsider with some background knowledge, but with a keen interest in learning about the individual participants (Lofland and Lofland, 1995). A polite, unthreatening and ever-approachable presentation was maintained, but always balanced with impartiality. As Lofland and Lofland (1995) warn of unwitting association with particular factions in the research site, the author needed to be friendly enough to encourage the participation of each firm in the population, without alienating or causing jealousy between fiercely competing enterprises or individuals.

5.2.2.6 Participant-researcher relationship

In the manner of Zhang et al. (2006), the researcher conducted interviews and observation as a paying guest at the participating guesthouses. In an attempt to compensate participants for their considerable time spent in interviews, whilst

avoiding the ethical question of paying for information or offering a findings summary that may have been of little interest to the participants (Michailova, 2004), the author offered tuition in English conversation. This type of arrangement had worked well during the exploratory trip. An exchange of time and skills was thus proposed, rather than a direct demand for participants' time that was not compensated by the hotel bill, or that would suggest a guest-host power relationship (Swain, 2004) – and the researcher came off worse in this bargain, on more than one occasion. Tension in the researcher's dual role as paying guest and researcher arose on three occasions, when participants postponed previously agreed interview times with the consequence that the researcher had to stay another night (experiencing opportunism at first hand, perhaps). This was successfully resolved with two participants, and the third was the non-participating interviewee who withdrew during the course of the study.

After initial access had been secured, the foreignness of the researcher generally continued to enhance the relationship. In the context of researching Chinese businesses, foreign researchers are still more of a novelty than a commonplace nuisance (Hansen, 2008). The very fact that the researcher was foreign meant that she could ask questions or be forgiven for mistakes that a local could not (Yanagisako, 2002), and felt that “for some respondents, the fact that I was not part of local kinship or social networks enhanced the degree of openness and trust possible” (Wilson, 2004: 435). The corresponding disadvantage is naturally the risk of missing nuances in some responses, but the author considers this worthwhile in a study that otherwise capitalised on her individual characteristics that were helpful to the relationship (Chapman et al., 2004).

5.2.3 Context interviews

As mentioned in section 5.1, it was important to obtain reports independent of the participants in the field study, regarding the broader research context. In addition to the field interviews, context interviews were therefore conducted with relevant government bodies and professionals who were not directly associated with the field site (Yanagisako, 2002). This was intended to support or give an alternative perspective on the field participants' reports (Stone and Wall, 2005), with the aim of allowing an outside view to challenge the privilege that this study would otherwise have accorded to these reports (Yanagisako, 2002). Over three years, these context interviews have included representatives of local governments, tourist boards, investment promotion bureaux, universities, banks and law firms, in Kunming and Chengdu (the capitals of the Western provinces of Yunnan and Sichuan, respectively).

Access was negotiated more formally than for the field interviews. It drew procedural credibility and increased formality (Yeung, 2004) from introductions made through intermediate contacts (Thomas, 1996) in the British Chamber of Commerce in Southwest China, the British Academy, the Department for International Development and the United Nations Development Programme. This approach is particularly recommended for attempts to gain access to "political, legal or bureaucratic units of the nation-state" (Lofland and Lofland, 1995: 41).

Most of these Chinese interviewees were confident speakers of English, having been introduced via British or international intermediaries, so interviews were conducted in English without serious implications for linguistic advantage. The opportunity still arose for the author to clarify points using Chinese, or in the case of a local government interview when an interpreter was provided, to pick up further nuances in the slight changes or omissions made in translation. The author also continued to

make use of her foreignness to pursue sensitive questions such as whether the banker could trust borrowers' signed guarantees, and to what extent local government policy was disseminated freely, despite signals of discomfort that a local would observe and respond to.

5.2.4 Data management during the collection period

During field and context interviews, the researcher made handwritten notes that she typed up soon afterwards. All interview records were anonymised to safeguard the confidentiality of the participants, and the "key" to identifying the records was stored separately.

As the context interviews each addressed very different topics, no standard format was used for writing them up. Each interview was simply typed up in Microsoft Word, with references to the literature maintained. The field interviews, in contrast, were all typed up in the same format, facilitating cross-reference from the responses to the literature driving the question, and between respondents. This was done in Microsoft Word tables, to prepare for a straightforward consolidation of interview summaries into a single (but very large) grid for Framework analysis (see section 5.3.1) following the field research period – up to this point, all input, storage and retrieval was in electronic format. This grid was later printed onto a series of A0-size posters, to aid data visualisation during thematic analysis and coding by the researcher.

5.3 Research design: data analysis

The data analysis was performed in three distinct stages, each with its own purpose. The first stage was a cross-firm thematic analysis of the interview data, exploring the range of participant responses and the degree of agreement shown with the literature,

and answering the first two research questions. The second stage involved coding interview data as fuzzy sets, in preparation for analysis. The third stage used the Qualitative Comparative Approach (QCA), which is a systematic data analysis method that supports theory-building by cross-case comparison. This technique was chosen for this study because it is designed to help analyse causal complexity, which was considered to be critical to the understanding the interaction between institutions and isolation in answering the third research question.

In the following paragraphs, each of these stages will be described and its use in this study justified. The results of the thematic analysis are presented in Chapter 6, whilst the use of fuzzy set coding and QCA analysis in deriving the findings are explained in detail in Chapter 7.

5.3.1 Thematic analysis

A preliminary review of the interview data was conducted prior to the thematic analysis and fuzzy set coding, to familiarise the author with the responses and to make overall quality checks (Ritchie and Spencer, 1994). These included checking for completeness and consistency within case firms, inserting cross-references between cases, and adding impressions or observations to cases where, on reflection, they became relevant. Areas of commonality were noted, as were tensions or contradictions within and between cases.

The underlying technique used to analyse the individual interview records into thematic summaries was the Framework method (Ritchie and Spencer, 1994). The thematic framework draws on the original research aims, emergent issues raised by the participants, and analytical themes arising from recurrence. This is presented as a grid, with a theme in each row and a column for each participant; extracts from the interview data can then be arranged in accordance with the themes, but still kept

separate for each participant. This has the advantages of ensuring the full and systematic review of all the material collected, of avoiding partial or selective inclusion into the analysis, and of making the comparisons between participants very transparent. The grid was constructed in a table in Microsoft Word: although specialist software is available for this task (FrameWork software from the National Centre for Social Research), the author did not consider it to offer substantial analytical advantages.

The results of this comparative analysis are presented in Chapter 6. This presentation was structured in keeping with the main ideas in the literature, offering clarity and continuity between the literature review and the presentation of findings. The broad themes presented each draw upon multiple interview topics, and later feed the coding of multiple fuzzy set codes (Bryman, 2008).

5.3.2 Fuzzy sets

Fuzzy set coding is a method of reducing interview data into summary form for analysis of patterns and interaction between the sets, without the loss of detail that results from binary coding. For example, the membership of crisp sets has a binary definition of 0 or 1, indicating that a case is a full- (1) or non-member (0) of the set. In contrast, fuzzy set membership has values ranging from 0 to 1 inclusive, to describe a full range of membership from non-membership (0), partial membership ($1 > x > 0$), and full membership (1) of the set. Ragin (2000) attributes the first use of the term “fuzzy” meaning varying degrees of membership in a set, to Zadeh (1965: 338): “A fuzzy set is a class of objects with a continuum of grades of membership... ranging between zero and one”.

Researchers should use theory to guide their selection of causal conditions to code as fuzzy sets (Berg-Schlosser et al., 2009), as described in recent studies on the

performance of industrial clusters (Öz, 2006) and on the influence of institutions on inward FDI (Pajunen, 2008). The literature reviewed in Chapters 2 and 4 identifies the theoretical strands of transaction cost and institutional theories that guided the researcher's choice in this study. The link between literature and the interview topics derived from it is further strengthened by the calibration of set values to reflect both theory and empirical findings from the field (Ragin, 2008a). The first stage in this process is the siting of the qualitative anchors of 0 and 1, to contain the relevant variation in the empirical data with regard to the conceptualisation of the set. For example, a set conceptualised as describing "large firms" might have the upper bound (membership score of 1) set at a particular value of turnover, above which any variation is not considered to be meaningful with regard to the underlying concept; equally, turnover anywhere below another set value might constitute non-membership, and so the lower bound of relevant variation (membership score of 0) does not extend as low as a turnover of zero. The researcher therefore needs to interpret actual turnover values with reference to the concept of firm-size categorisation, rather than using them to populate a ratio-scale variable of firm turnover – which also would be limited to a lower bound of 0. The setting of upper and lower bounds, or minimum and maximum values, distinguishes fuzzy sets from ratio variables with their limitation to a minimum value (Ragin, 2000).

The third anchor, 0.5, is again set with reference both to the literature and to the empirical data. Ragin (2008a) points out that that this offers the researcher the opportunity to determine the point of maximum ambiguity between full- and non-membership of a case in the theoretically determined set, rather than having to assume it to equate to the central tendency of the sample (as was done in the study by Schneider et al., 2010). Following the establishment of these three qualitative anchors, further incremental values can then be set to reflect the quantitative variation evident in the data. The number of values for each set is established by the

researcher depending on the level of theoretical and empirical detail available, and would typically comprise three (0, 0.5, 1), five (0, 0.25, 0.5, 0.75, 1) or seven (0, 0.17, 0.33, 0.5, 0.67, 0.83, 1) values. It can be seen that calibrating fuzzy sets is an interpretive process, which is distinct from defining ordinal, interval or ratio variables (Ragin, 2008a):

Fuzzy sets are fundamentally *interpretive tools* – they operationalise theoretical concepts in a way that enhances the dialogue between ideas and evidence. With fuzzy sets it is possible to establish a much closer fit between theory and data than is possible using conventional procedures (Ragin, 2000: 162, italics in original).

The fuzzy sets used in this study represented the causal conditions (relating to perceptions of transaction costs and institutions) and the outcome condition (isolation from or integration into the market) under examination. The coding of interview data involved assigning case-firms to levels of group membership for each causal condition and the outcome condition, to enable an assessment of the strength of any apparent relationship between cause and outcome. The Data Reduction section of chapter 7 explains, with reference to a worked example, how the sets in this study were calibrated and scored, resulting in a series of conditions “carefully tailored to fit [the] theoretical concepts” rather than ready-made measures (Ragin, 2000: 4). As the researcher documented the steps taken in the selection, calibration and coding of fuzzy sets, and the reasoning for them, an audit-trail of coding decisions was generated to support the reliability of the subsequent interpretation (Silverman, 2005).

This method is appropriate to the author’s current study, because it matches both the data and the aims of the research. Fuzzy set coding of interview questions has enabled reduction of the field data, without the loss of detail that would have resulted from coding into crisp sets or other types of variables. Fuzzy set scores based on

ethnographic or interview data are intended to understand the conditions from the point of view of the research participants (Ragin, 2000), which is consistent with the research aims of understanding participants' perceptions of transaction costs and institutions, and abductive theory-building from their interpretations. Fuzzy set analysis has been recommended for the study of transaction costs, in particular for bounded rationality and uncertainty, due to its lack of dependence on or sensitivity to assumptions (Rao, 2003). Pajunen (2008) recommends the use of fuzzy set analysis at the micro level, as demonstrated in a comparison of organisational configurations (Fiss, 2007) and an analysis of market research surveys (Kent, 2005). Berg-Schlusser et al. (2009) suggest that any subjective or qualitative data that can be transformed into categories or numbers can be analysed with fuzzy sets, and Haegel (2007) demonstrates this with a fuzzy set analysis of the characteristics of EU negotiations on data collected through interviews and participant observation. Ragin (2000) confirms the applicability of fuzzy sets to the operationalisation of concepts, in his description of fuzzy sets as a:

...system designed to join formal logic, which is crisp and precise, and verbal concepts, which are not.... Virtually all social science concepts are verbal formulations. Thus, fuzzy sets are useful not only for representing membership in social categories [,] but for operationalising any social science concept that addresses differences across cases or instances (Ragin, 2000: 160).

The purpose of fuzzy set analysis is to explore combinations of and interactions between the theoretically-selected causal factors, rather than to discover new themes in the data. We have explained that this study used causal conditions selected from theory and formalised in the thematic analysis. As such, a variety of well-known computer-assisted qualitative data analysis (CAQDAS) packages are designed specifically to uncover themes in the data – such as Nudist, ATLAS.ti and NVivo – are unsuited to this study. This study does, however, enjoy the benefits of systematic,

comprehensive and exhaustive data analysis (Gephart Jr., 2004) and generation of an audit trail that are common to software-assisted study (Lindsay, 2004), as will be described in the section on the fsQCA software.

5.3.3 The Qualitative Comparative Approach

This section is intended to introduce the Qualitative Comparative Approach (QCA) and justify its use in this study. Section 5.3.4 will describe the associated analytical procedures in detail.

QCA is a transparent, systematic data analysis method in support of theory-building rather than hypothesis-testing, that was originally developed in the late 1980s in the fields of comparative politics and historical sociology (Rihoux and Ragin, 2009). It is a cross-case comparison that considers each case as a configuration of causal factors or conditions, emphasising the exploration of theory-driven relationships between the conditions describing a small number of cases (Ragin, 2000). It helps to formalise the process of observing commonalities in the data, and creates an audit-trail of the steps in data analysis to support the reliability of the interpretation. QCA can be seen as both deductive, as theory guides the selection of conditions, and inductive, as the cases offer insights as to further conditions to examine (Berg-Schlosser et al., 2009).

Because this approach takes a holistic view of the cases as configurations of features (Haeger, 2007), it emphasises the consideration of the context in which the cases are situated, and the potential impact of the context on the causal connections under study (Ragin, 2000). This fits well with the current study's critical realist perspective that explores actors' perceptions, their institutional environments and the interactions between them, and also the combined causes of transaction costs.

QCA uses Boolean logic to propose set-theoretic relationships between the fuzzy set scores representing causal conditions and the outcome condition. For each case, if the score on the outcome condition is lower than the score on a causal condition, then the outcome is a subset of that cause, indicating that the cause is a necessary condition of the outcome (Ragin, 2000). This is illustrated as a Venn diagram in Figure 6 below, taking the form of concentric rings with the outcome completely surrounded by the cause, showing that the outcome is always associated with this cause. An outcome score greater than the causal score indicates a sufficient cause, and the cause is a subset of the outcome. This ability to distinguish between necessary and sufficient conditions is of recognised value to applied research in the fields of social policy (Ragin, 2000) and local economic development (Ostrom, 1992).

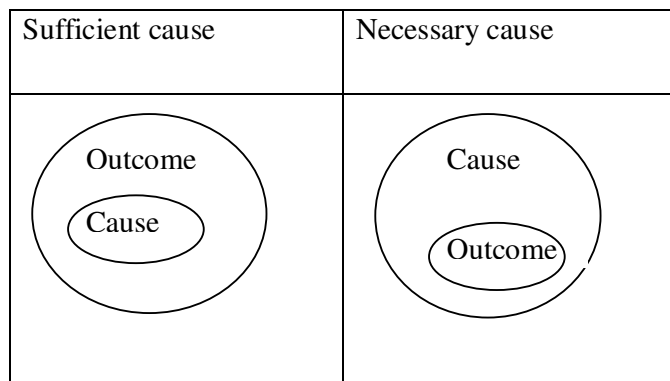


Figure 6 Illustration of necessary and sufficient causes

(Source: author)

Scores for combinations or configurations of causal conditions are found by taking the maximum score of all the conditions in the configuration for the union of the fuzzy sets (a Boolean ‘OR’, as in “a OR b OR c”), or the minimum score for the intersection between the sets (Boolean ‘AND’, as in “a AND b AND c”). The configuration of conditions that are associated with a given outcome in any case can

thus be compared with configurations that are associated with similar outcomes in other cases. In a group of cases whose scores for the cause is consistently lower than their scores for the outcome, a subset relation can be demonstrated; the researcher may then interpret this as a sufficient cause with reference to his substantive and theoretical knowledge (Ragin, 2009). This “causal interpretation of an association” (Olsen, 2004: 1) is an argument that can be supported by the scores; it is not claimed to be proof of a cause-and-effect relationship. Illustrated on a scatter-plot, with causes on the x -axis and outcomes on y , cases indicating sufficient cause would cluster above the diagonal towards the upper-left of the plot (where $y > x$) – see Figure 7 below. A case to the extreme top-left of the plot would not be considered an outlier, but rather a very strong member of the outcome set, but with further – as yet unexplored – causes that could be incorporated into the causal statement to bring the case closer to the diagonal (Ragin, 2005b).

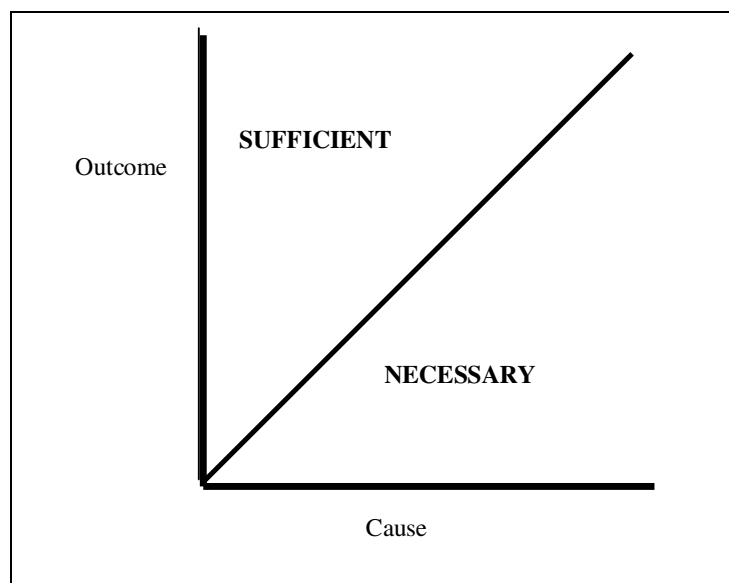


Figure 7 Example of plot showing necessary and sufficient causes
(Source: author)

Ragin (2000) contrasts variable-oriented quantitative research, which seeks correlations across many cases and assumes the effect of each cause to be independent of the next, with QCA's case-oriented approach. This focuses on the in-depth study of a small number of cases, anticipating that causes will act in combination, and seeking out diversity between cases that might only be reflected in a single condition. The conditions are not separable from each other, from the case or from the context; the case is a "complex combination of properties, a specific 'whole' that should not be lost or obscured in the analysis" (Berg-Schlosser et al., 2009: 6). This suggests micro-level study, as "cases should be well known rather than anonymous" (ibid.).

QCA adopts a complex conceptualisation of causality. It may be multiple, if there are many alternative causal paths (indicated by an 'OR' statement), and/ or conjunctural where each path composed of a combination of causal conditions (indicated by an 'AND' statement) (Berg-Schlosser et al., 2009). Contingent causality describes interaction effects between causal conditions, resulting in a condition having two different outcomes (Ragin, 2000). For example, fear of opportunism (Condition1) might be associated with isolation (positive outcome) in firms lacking legal protection (Condition2), but might be associated with integration (negative outcome) in firms with legal protection. QCA, in contrast with statistical approaches, does not assume additivity (each causal factor having its own, independent effect on the outcome), causal symmetry (where the presence and the absence of the outcome are explained by opposite causal factors) or uniformity of causal effects (the causal factor always having the same effect on the outcome, regardless of its combination with other causes). It does, however, allow for equifinality, whereby different causal paths may lead to the same outcome (Berg-Schlosser et al., 2009). This reinforces QCA's emphasis on configurations of causes, and its search for the different causal models present in the data's comparable cases rather than seeking a single causal

model with “best fit” to all data. Rather than averaging out distinctions between cases as statistical methods would – for a relevant example, see Peng’s (2004) study of entrepreneurship and institutions in Chinese villages – QCA highlights diversity in order to refine theory and propose analytic generalisation (Öz, 2006). Berg-Schlosser et al. (2009) recommend “modest” generalisation to cases similar to those included in the empirical dataset used in QCA, and reiterate Ragin’s (2005b) point that QCA is not intended for making statistical inference from sample to population but rather to assist in causal interpretation. QCA’s combination of case-orientation and complex causation has been recommended for research very similar to the current study, where complex patterns are sought at a micro level:

The aim of this paper is to advocate the use of this method in the IM [international management] field to delineate patterns of causalities or regularities in microsociological phenomena embedded in historical contextual singularities (Saka-Helmhout, 2009: 4).

QCA is particularly appropriate to this study, in its characterisation as a small-N approach (with a population in the range of 2-15 cases) that originates from its early application in macro-comparison between countries (Rihoux and Ragin, 2009). Its requirement for an in-depth knowledge of individual cases fits the current research design, in which “the researcher is able to engage in regular interaction with the individuals (the ‘cases’) that are the object of the study”, and where the number of cases is small enough to permit real familiarity by the researcher (Berg-Schlosser et al., 2009: 4). Such analysis is well suited to qualitative data (Rihoux et al., 2009), such as that collected in this study. QCA permits analytic generalisation from small-N studies (Öz, 2006), and Berg-Schlosser et al. (2009) cite several such studies published in the fields of politics and management research. QCA is also more appropriate to this study than cluster analysis. Although the input data and first stage of analysis may appear similar in QCA and cluster analysis – the truth table and the matrix of interobject similarity (Lorr, 1983), respectively – the aims are very

different. QCA's aim of making complex causal interpretations by investigating subset relations diverges greatly from cluster analysis's grouping of cases into homogenous classes or clusters, for the purpose of constructing and testing a hypothesised scheme of classification.

5.3.4 fsQCA Software

fsQCA (fuzzy set Qualitative Comparative Analysis) is a software package developed by Charles C. Ragin specifically to assist in QCA studies, by adding speed and systematic rigour to the processing of data to aid the observation of complex causal configurations. Transparency and traceability are ensured by a package that “opens the ‘black box’ of formalised analysis, by demanding from researchers not only that they make choices but also that they account for them” (Berg-Schlosser et al., 2009: 14). This analytical approach will assist this study's critical realist comparison of idiographic cases (Sharpe, 2004), and it fits well with a methodology that aims to study cases in depth, but also in relation to theory and to the constraints imposed by contextual factors such as institutions. The software version used in this study was v2.2, dated December 2007; at the time of writing, an incremental update was available (v2.5, June 2009) which maintained the same core functionality.

Summary fuzzy set scores are imported into the fsQCA software as cause or outcome conditions. fsQCA then summarises the configurations of causal factors that exist in the data, and displays them in a “truth table”. Truth tables are used to evaluate the argument of causal sufficiency, based on the strength of the subset relationship where membership scores in the causal conditions are consistently less than or equal to the scores on the outcome. The rows of the truth table each represent a case, or a configuration of causal factors, and these rows correspond directly to the corners of the multi-dimensional vector-space that is described by the conditions. fsQCA calculates the membership score for each case in each corner of the vector-space with

Boolean algebra; as each case may have varying degrees of membership in the different corners, fsQCA makes statements about the characteristics of the corners and summarises them in the truth table (Ragin, 2005b). As such, each row in the truth table has a score of 1 or 0 for each condition in a causal configuration; the corners are where the presence or absence of the conditions meet in combination (so “a AND b NOT c” describes a corner). In the simple example in Table 1 below, Case1 has strong membership of both Condition3 and Condition4 (so could be described as “3 AND 4”), whilst Case2 has strong membership of Condition3 but weak membership of Condition4 (so could be described as “3 NOT 4”).

Table 1 Example of a truth table

(Source: author)

	Condition3	Condition4
Case1	1	1
Case2	1	0

Because this highlights where various causes are associated with a common outcome, or where causes unexpectedly are not associated with an outcome, the researcher is prompted to explore the data further (Öz, 2006). The software uses Boolean logic to assist the user in identifying necessary and sufficient causes or causal configurations, and reduces them to a series of algebraic statements (Rihoux and Ragin, 2009). Cases that match the statements but are not associated with the outcome are negative cases. They require further investigation into which element of their context, that is not accounted for by any of the conditions, causes them to behave as exceptions. The causal statements derived for this study are presented in the Chapter 7.

Published studies in International Business using fsQCA are still limited in number, and include those on the relationship between institutions and export performance (Schneider et al., 2010), institutional effects on FDI (Pajunen, 2008), internationalisation of small firms (Loane et al., 2006), and resource management by international organisations (Stokke, 2007). More numerous examples are available in related fields including corporate strategy (Kogut et al., 2004), market research (Kent, 2005), organisation studies (Fiss, 2007), determinants of corporate performance (Greckhamer et al., 2008), the comparative study of institutions (Kogut and Ragin, 2006), tourism research (King and Woodside, 2001), comparative politics (Schneider and Wagemann, 2005, Pennings, 2003) and cross-national economic performance (Vis et al., 2007).

Proponents of fsQCA have argued that its strengths include the use of counterfactuals (which enables inferences to be made beyond the observed data, and makes its treatment of them explicit), the equal weight it gives to all cases (which is in fact a strength for case-oriented studies that seek diversity), and the need to maintain an appropriate ratio of conditions to cases (which forces researchers to select the conditions with care, de Meur et al., 2009). Ragin (2005a) rejects charges that fsQCA is inferior to traditional quantitative techniques, highlighting its intended use for causal interpretation with small numbers of cases, in contrast to the causal inference from large numbers by correlational analyses. Fiss (2007) defends its ability to identify conjunctural causation, which is not matched by regression models, and Pajunen (2008) considers it more appropriate than conventional statistical techniques for studying causal combinations in small numbers of cases.

5.3.4.1 User interventions during the fsQCA analysis

This section outlines the choices that the user needs to make during the analysis. The actual decisions made during the course of this study are discussed in Chapter 7.

The truth table is used to evaluate an argument of sufficiency for the causal configurations it represents, and there are 2^k logically possible causal configurations (where k is the number of conditions). The truth table is therefore likely to contain rows with empirical cases, and rows without – whether because the vector-space has more corners than there are cases, or because a row represents a combination that would be impossible in reality (Ragin, 2000). This is a reflection of the limited diversity of social phenomena (Ragin, 1987), and the user must address it by assessing the distribution of observed cases across the logically possible configurations that make up the vector-space (Ragin, 2009). Each case is mathematically constrained to have a strong membership score (higher than 0.5) in only one configuration, and the user sets the minimum number of strong cases that merit the inclusion of the configuration in further analysis. This is the frequency benchmark for identifying empirically relevant causal configurations; any configurations falling below this benchmark are treated as logical remainders, and are removed from the truth table (Rihoux and de Meur, 2009).

The user examines the consistency scores of the remaining rows. This score calculates the degree to which the cases sharing the row's conditions display the subset relation of sufficiency; social scientific data are not expected to be so uniform as to demonstrate a perfect fit (Ragin, 2005b). It therefore measures the extent to which each configuration is a subset of (has a lower score than) the outcome. Where X is a cause, Y is an outcome, and MIN takes the lowest of two scores, this is calculated as:

Sum of MIN (cause or outcome) / Sum of all causes, or

$$\text{Consistency } (X \leq Y) = \text{SUM} (\text{MIN } X, Y) / \text{Sum } (X) \quad (\text{Ragin, 2009})$$

The score would be 1 for perfect consistency (where the causes score less than the outcome for all cases), slightly lower for a few near misses, or much lower (below 0.5) for many cases with a wide margin. High scores would cluster in the upper-left of a plot of causes against outcome, indicating that the causes are sufficient for the outcome. The user selects a threshold value for consistency, and codes the outcome to 1 for rows above this threshold, and 0 for rows below it. The truth table now illustrates the empirically observed configurations of causes that are associated with the presence (1) or the absence (0) of the outcome (Ragin, 2009).

The truth table may contain contradictions, which can be crisp (a row in which some cases are associated with the outcome and others are not) or fuzzy (a row that is associated with the outcome but has a low consistency score) (Ragin, 1987). Although the presence of contradictions confirms that the ratio of cases to conditions is appropriate for fsQCA processing (Marx, 2006), they must be resolved through reexamination or recoding of the data (Ragin, 2009) before minimisation can proceed (Rihoux and de Meur, 2009).

Minimisation is a series of logical reductions to derive complex, intermediate and parsimonious solutions, based on an algorithm first developed in the 1950s by Quine and McCluskey to simplify electrical switching circuits. Simplification in fsQCA is desirable to enable generalisation from cases, rather than just providing descriptions of each case. The complex solution may have many terms, as it can only reduce very closely matched pairs of truth table rows into a single solution term, and exercises no assumptions regarding logical remainders (Ragin and Sonnett, 2008). This may result in a descriptive formula with very little generalisation, reflecting an early stage of interpretation (Rihoux and de Meur, 2009).

In order to achieve greater simplification under conditions of limited diversity, which lack identical cases from which generalisations can easily be drawn, the user must

make simplifying assumptions (Ragin, 2008b). This enables the analysis to move from a very complex expression that describes a subset of the observed cases, to a more parsimonious expression that describes more cases or achieves more generalisation. This is done by eliminating some conditions from the complex expression, even where there are no matched pairs of observed cases to support such elimination. A notional matched pair is created by selecting from the logical remainders (unobserved but logically possible causal configurations), and the simplifying assumption is made that – if the logical remainder had actually been observed – the presence or absence of certain conditions (as specified by the user) would be associated with the outcome (Rihoux and de Meur, 2009). In this respect the user can benefit from the unavoidable limited diversity of social phenomena, to provide counterfactual cases to simplify the results (Ragin, 2008b).

The use of simplifying assumptions in the reduction from the complex to the intermediate solution is controlled by the user. The assumptions take the form, “The presence of (condition X) should contribute to the outcome”, or “The absence of (condition X) should contribute to the outcome”. The user only enters assumptions that he considers to be “easy counterfactuals”, which are so called because their propositions are consistent with theory, even though they lack empirical observations (Ragin, 2008b). When fsQCA has generated an intermediate solution for each simplifying assumption, the user must identify the counterfactual configurations that have actually been exercised, and make his own assessment as to their plausibility with reference to theory and to substantive knowledge (Ragin and Sonnett, 2008). On this basis, the user decides which assumptions to retain, and so which of the proposed intermediate solutions to progress.

A further reduction is possible, from the intermediate solution to a parsimonious solution. This allows fsQCA to incorporate any logical remainders into simplifying

assumptions even if they constitute hard counterfactuals, without any intervention by the user, in order to reach the most simplified solution possible. The complex and parsimonious solutions should be seen as occupying opposite ends of a continuum rooted in the same evidence; the complex solution is a subset of the parsimonious, still retaining its key elements but with less tolerance of counterfactual simplification (Ragin, 2008b). The user's task is to choose between the extremes of a parsimonious solution that is simple and generalisable but is potentially over-simplified, and a complex solution that may have achieved little simplification but can be easily justified. Ragin's (2008b) conclusion is that the intermediate solution makes justifiable eliminations of surplus conditions from the complex solution, whilst retaining its subset relation to the parsimonious solution:

Intermediate solutions strike a balance between parsimony and complexity, based on the substantive and theoretical knowledge of the investigator (p175).

All solutions – parsimonious, intermediate and complex – are reported alongside scores for consistency and coverage. Whereas “solution consistency is the strength of the subset relation indicating sufficiency, ... solution coverage is the empirical importance of this relation” (Ragin, 2008b: 45). Coverage indicates the degree to which the solution accounts for instances of the outcome; if this were illustrated on a Venn diagram, with the sufficient cause being enclosed as a subset of the outcome, a higher coverage score would correspond to a greater overlap between the circles for cause and for outcome.

In a solution composed of more than one term or causal path, coverage scores enable the user to distinguish between the relative importance of each path rather than considering them all to be equivalent. A complex solution with many terms might have a high consistency score but low coverage for each term as each only describes an empirically trivial number of cases, which would undermine the consistency

argument (Ragin, 2008b). The user must therefore select the preferred solution based on the reasonableness of any simplifying assumptions made, the consistency scores and then the coverage scores.

5.3.4.2 Adjusting the ratio of conditions to cases

It was noted above that the ratio of conditions to cases is important to the quality of the study. In a study with too many conditions relative to the number of cases, it is likely that each case will comprise a unique configuration of conditions and be impossible to generalise from (Berg-Schlosser and de Meur, 2009, Marx, 2006), and a large number of logical remainders will result with consequences for the inferential authority of the study (Wagemann and Schneider, 2007). Whilst Ragin (1987) accepts that logical remainders are a natural consequence of limited diversity as the number of cases simply will be smaller than the number of causal configurations, Marx (2006) proposes that there should be fewer conditions than cases to avoid uniqueness, and suggests guidelines for an appropriate ratio of conditions to cases. Chapter 7 will illustrate these guidelines with reference to the study data.

A study drawing on rich theory is bound to comprise many conditions, and “a large number of conditions often cannot be excluded *a priori*” (Berg-Schlosser and de Meur, 2009). As the number of cases is generally fixed by the nature of the data collection exercise, the issue is how to moderate the number of conditions (Wagemann and Schneider, 2007) *a posteriori*. Ragin (2000) proposes mechanisms for the functional reduction of the number of conditions by creating higher-order constructs, by the methods of substitutability (replacing multiple substitutable conditions with a single expression, whose score is the maximum of the original scores) and of compensation (taking the average of the component scores).

The implication for the fsQCA analysis is that it will be iterative, as the user compares the relative merits of different approaches to the data in their attempt to produce a truth table free of contradictions (Rihoux and de Meur, 2009).

Those readjustments should not be considered opportunistic manipulations of the data [because they are necessary and follow] formal rules that are fixed and stable, [and] they allow replicability. Simply stated, this means that another researcher using the same dataset and selecting the same options will obtain the same results (Berg-Schlosser et al., 2009: 14).

Chapter 7 shows how the interview data were coded into 12 fuzzy sets, this being the largest number of conditions appropriate to the 13 cases, and it presents the iterations in the fsQCA analysis that concluded with a six-condition model.

5.4 Ethical issues concerning data collection

The study received ethical approval by the author's academic department (the University of Edinburgh Business School), and the data collection was conducted in compliance with the ethical guidelines adopted by the Association of Social Anthropologists of the UK and the Commonwealth (ASA, 1999). The study was funded by an Economic and Social Research Council studentship, and so no pressure or conflicts of interest were introduced by commercial funding.

Participants' agreement to participate in the study was secured verbally, as "signing an informed consent form ... may be undesirable, impolite or impossible in certain locations" (Punnett and Shenkar, 1996). This departure from common Western practice was supported in the author's consultation with two senior academics in Western universities, who are active in the research of Chinese politics. Both recommended basing verbal consent on an explanation of the purpose of the research, and using this to justify non-attributed quotation of the participants' speech.

The researcher discussed anonymity with the participants, rather than assuming that it would be desired in all cases (Grinyer, 2003). Whilst no participants wished to have material attributed directly to them, some asked for their firm to be named in a list of contributors in the hope of attracting a little publicity.

CHAPTER 6 THEMATIC ANALYSIS AND DISCUSSION

The previous chapter presented the research methodology, including the data collection techniques and the method of data analysis, and explained that the participants would be referred to as P_n . The numbering of the 13 is not continuous because the total population originally identified contained 16 firms; the numbers in use are P1, P2, P3, P4, P5, P6, P7, P10, P11, P12, P13, P14 and P16. This chapter presents a cross-firm thematic analysis of the interview data, showing the range of participant responses and the degree of agreement they show with the literature, with regard to the causes of transaction costs, their responses to them, and the strength or weakness of institutions. It answers the first two research questions, and offers a preliminary answer to the third question. The purpose of this chapter is to familiarise the reader with the detailed findings, before Chapter 7 describes the data reduction and analysis, followed by a full discussion of the third research question in Chapter 8.

6.1 Causes of transaction costs

6.1.1 Bounded rationality

Bounded rationality in the form of information asymmetry (Williamson, 1975) was readily grasped by P11. The other participants understood an example of information known to sellers but not to buyers (North, 1990), which is a feature of local trading custom where prices are not displayed but are negotiated separately with each buyer. The difficulty for buyers of establishing fair prices for goods was identified as a cost and a trading risk by five participants (P1, P2, P3, P7 and P11). A further five firms (P4, P5, P6, P12 and P14) acknowledged the additional cost entailed by comparing or negotiating prices, but did not consider this to increase risk. Only P10 did not

perceive any asymmetry, and P13 and P16 felt able to overcome it with no transaction cost implication. Perceived asymmetry did not simply increase with distance from the market town of Qiaotou, indicating that relative location is less important for these small firms than He (2002) reports for national firms.

Language often hindered participants' understanding of customer transactions (Buckley and Chapman, 1998d), with few clients speaking Chinese. P2, P3, P11 and P12 were frequently prevented from entering into transactions by the language barrier which became self-perpetuating, and P5, P6, P7 and P13 spent additional time seeking to ensure their understanding of transactions. Only P1 claimed never to have incomplete understanding.

Bounded rationality had little perceptible impact on the capacity for planning (Williamson, 1975), as the majority of cases simply do not attempt this. Only firms P10 and P13 reported a constraint on planning, and P5 was able to plan over a one-year time horizon. The remaining firms were accustomed to responding to demand rather than planning, offering little evidence either way.

The completeness of contracts (Williamson, 1985, Williamson, 1975) and the cost of monitoring counterparties to contracts (North, 1990, Zhou and Poppo, 2008) turned out not to be appropriate to the context, as verbal agreements are the norm. The only reported contracts concerned construction at P1, where the work would be performed on site and so be easy to monitor. P4, P6, P13 and P14 thought that bounded rationality was preventing them from entering into contracts, but section 6.3.3 will also address the barrier presented by the legal system.

6.1.2 Opportunism

The majority of interviewees were aware of opportunism, whether as an exception (P3, P5, P6 and P13) or as the rule (P1, P4, P7, P11 and P14). The reported forms of opportunism centred on information: distorting or hiding information, or charging unfair prices. There was no reported crime or contract-breaking (Williamson, 1985), and most reports were of active opportunism (Wathne and Heide, 2000) although P4 offered examples of passive failure to offer complete information. Of the participants acknowledging opportunism, all felt some weakness in their ability to identify potential opportunists (Douma and Schreuder, 2008), to retaliate against opportunism (Carson et al., 2006), or in the protection afforded by institutions (Zhou and Poppo, 2008).

Although many participants had experienced opportunism by suppliers (reported as frequent by P1, P7, P11 and P14 and exceptional P4, P5, P6 and P13), only four (P1, P3, P7 and P11) had acted on any fear of opportunism (Williamson, 1985). Further questioning showed that the perceived threat of opportunism receded because participants had already guarded against it through exclusively personal trading (North, 2003) that enabled them to rely on their prior knowledge of the counterparties (Douma and Schreuder, 2008) – thus incurring transaction costs of a different nature than the internalisation or cooperation predicted by theory. Only P1, P13 and P16 were willing to trade with strangers; all others restricted their volume of impersonal trading or avoided it altogether, demonstrating an unsatisfied need for institutional protection.

The only example of *ex post* opportunism (Buckley and Chapman, 1998a) was customers failing to pay their bills (P1, P7 and P14). P10 offered an opportunity to triangulate the methods of interview and observation, as she denied the existence of

opportunism of any kind, and yet was one of only two participants to charge guests in advance – the other being P7, who did this specifically to avoid non-payment.

Outside the customer-supplier relationship (Schauwecker and Kühlmann, 2007), opportunism by competitors was only reported by P1 and P3. P3, P4, P6 and P14 reported observing opportunism by locals against customers, with P6 incurring extra costs by offering free meals to local horsemen, whom some participants suspected of overcharging (and so deterring) customers.

The author considers Hill's (1990) expectation that opportunists would be eliminated by the market not to apply in this context, as the risk of opportunism is strongly perceived by the participants.

6.1.3 Transaction characteristics

Specificity was investigated in terms of provision by guesthouses for individual tour operators. There was no specific investment in fixed assets (Lamminmaki, 2005), staff training (Langlois and Robertson, 1995) or dedicating staff (Poppo and Zenger, 2002) to meet the unique needs of tour operators, but this might change as operators come under increasing government pressure to employ local tour guides (which was reported by tour operator TO2). Although some firms have standing arrangements with tour operators (P4, P5, P6, P7 and P13), these are not formal enough to have led the tour operators to make specific investments or to demand this of the guesthouses. The only commitment of resource (Williamson, 1991) was temporary exclusivity of use when guesthouses were fully occupied by a single tour group, which had happened in just three firms (P4, P6 and P14). P6 was aware of dependence on these clients but perceived no risk in it, whilst P4, P7 and P10 associated dependence with risk and so took deliberate action to avoid it (Rao, 2003).

Transaction frequency concerned the planned recurrence of customer (i.e. tour operator) and supplier transactions (Colbert and Spicer, 1995). Short- or long-term planning with tour operators (up to one year ahead, within the annual budgets set by tour operators) was more common (P6, P13 and P14) than having standing arrangements with a supplier (P12), but neither was ever governed by a contract (Williamson, 1985). Active attempts to nurture long-term, if non-contractual, relationships were not widespread, but far more common with customers (P4, P5, P6, P13 and P14) than suppliers (P1 and P12).

Williamson closely associates specificity and frequency to changes in the governance of the transaction or the firm. Since these firms display largely non-specific non-repeated transactions, their failure to adjust their governance structures (see section 6.2.1) does not contradict his theory, but suggests that Nooteboom's (1993) expectation of small firms experiencing behavioural transaction costs might apply more readily.

6.1.4 Uncertainty

The author had expected to hear serious concerns about uncertainty, as three participants in the 2007 exploratory study (named P4, P5 and P7 in 2008) had told the author of their fear of a rumoured (and still uncertain) government proposal to build a series of hydro-power dams across the gorge with consequent flooding and forced relocation. Hayes (2007) identifies the parties to this proposal as the Huaneng Power Group and the Yunnan Provincial Government. Soon after the exploratory study, the nongovernmental organisation International Rivers estimated that 100,000 residents would be displaced (2007). Despite this, only five participants (P1, P2, P4, P5 and P7) in the 2008 data collection expressed concern for their firm under uncontrollable risks and an uncertain future. With the exception of P11 and P12, all others were aware of the risk but remained unconcerned by it.

Perception of risk in some areas was reduced because of the impossibility of foresight (Wholey and Brittain, 1989, Dess and Beard, 1984). For example, despite the Sichuan earthquake just four months earlier, participants did not worry about natural disasters (Williamson, 1985) – P12 observed that she couldn't predict or control these things, so it would be pointless to worry about them. Actions by others, including government policy (Guler and Guillen, 2010) and changing customer demand (Williamson, 1985, Werner et al., 1996) were mostly seen as beyond their knowledge, although P4 (and in relation to other questions, P1, P3, P6, P7, P10, P13 and P16) associated visa restrictions for the 2008 Beijing Olympics with a sharp fall in demand. The economy (Werner et al., 1996) had caused P3, P4, P7, P13 and P16 to raise their prices in response to inflation, but only P4 was aware of the further risk to demand by the unfolding banking crisis. The slow pace of improvement to transport and telecommunications infrastructure suggests that technological change does not have a strong impact on firms' decisions, supporting Williamson (1985) rather than Tremblay (1998).

Concern focused on increasing competition (Sutcliffe and Zaheer, 1998), and uncertainty about whether, when and how high the dam would be built. The variation in participants' perception of the risk demonstrates high uncertainty: P1 does not expect to be flooded, although her guesthouse is the lowest at about 20m above the current river level, whereas fearful P7 is sited 500m higher. As P4 explained, "The government is deliberately keeping business people ill-informed".

There was no adaptation of strategy or structure in response to uncertainty, and there were few contracts to adjust (Krishnan et al., 2006; see section 6.2.1). Only P1 and P4 have contingency plans in the event of flooding by the dam, and the non-participating interviewee had already petitioned the National Government's Development and Reform Committee. Other participants did not protest, some

because they felt powerless (P1, P5, P7, P12, P13 and P16), and others were too afraid as illustrated in the 2007 exploratory study.

No participants avoided trade in response to uncertainty (Keister, 2001), although section 6.2.4 will show avoidance for other reasons. The participants' priority was business survival and competitiveness, rather than reducing transaction costs for fear of the unknown (Martinez and Dacin, 1999). P5 fears losing everything if the dam should be built, but his immediate need is to extend and upgrade his accommodation to meet demand and to beat the competition. Similar views were expressed by P6, P7, P12 and the non-participant: trading and capital investment are not discretionary, they are a business imperative, and responding to uncertainty with contracts, modified governance or reduced trade would not increase the prospects of these firms. In contrast, TO2 and P4 reported that international tour operators avoided contracts because of uncertainty, showing they perceive a wider range of options including cooperative relationships. This suggests that a Western conception of uncertainty as undesirable, and responding to it by (incurring transaction costs whilst) attempting to reduce or work around it, does not apply in this context: the research participants conduct business as usual regardless of their uncertain environment, incurring no additional costs. In contrast, later discussion will show the participants' attempts to work around weak formal institutions or substitute for them with informal institutions.

6.1.5 Research question 1

The first research question asked which types of transaction costs were perceived by participating firms. The most widely-reported type was opportunism, with all interviewees who acknowledged it feeling some weakness in their ability to identify or retaliate against opportunism, or in the protection afforded by institutions. Almost all firms perceived risks of opportunism in impersonal trade, and avoided it or felt

constrained from trading more widely. Bounded rationality raised the cost of information search, and uncertainty was extremely high due to the possible dam. The transaction characteristics of specificity and frequency showed little variation in this context.

Behavioural causes are key to the firms' perception of transaction costs, in contrast to the minimal impact of transactional causes. Their decisions are thus steered by a need to protect the business from uncertainty, opportunists and the effects of bounded rationality, rather than by a wish to economise on the costs of repeated transactions. As such, the interview findings support the view of Nooteboom (1993) that these small firms will incur high transaction costs associated with opportunism, uncertainty and bounded rationality, and McGee and Sawyer's (2003) related observation that costs of information search will be higher for such firms.

6.2 Responses to transaction costs

As discussed in Chapter 3, a sensitising concept of isolation was adopted to guide the exploration of firms' responses to transaction costs the principal field study. Guided by the literature review, this was structured around the responses of transaction governance, organisation structure, specialisation and isolation. Section 6.1.4 has shown that uncertainty alone does not cause the firms to avoid transactions, so any avoidance here may be a response to other or multiple causes.

6.2.1 Governance of supplier transactions

Arm's length, market transactions with many suppliers were reported by P5 and P13, and with few suppliers by P2. These market transactions did not tend to involve contracts at all, which were only reported for P1's construction work, and leases between the local government and the two Qiaotou firms. Although arm's length

governance is expected when specificity and frequency are low, the uncertain environment explains the low incidence of arm's length trading (Williamson, 1985) and contracts (Zhou et al., 2008). Uncertainty is expected to lead to relational governance (Williamson, 1985), which was reported with small numbers of suppliers by P7, P10, P14 and P16, but this could be ineffective if opportunism were also present (Carson et al., 2006). The remainder of the firms reported that their transactions were not relational, but not quite arm's length either, as they were conducted within a pool of regular and trusted suppliers.

6.2.2 Organisation structure

No firm had taken over or been taken over by another, or been party to a parent-subsidary relationship or to a formalised cooperative relationship. The only relationships approaching a (modified) vertical structure were P10's affiliation with China's Youth Hostelling Association, which provides online marketing but takes no share in the ownership or management of the guesthouse, and long-standing but informal cooperation between tour operator TO2 and guesthouses P6 and P13. It should be noted that the participants described valued working relationships with TO2, which sounded less personal than the close relationships and even friendships that had been described to the author by TO2. This may be due to exaggeration on TO2's part, or may be due to the manager's comparison with his firm's commercial relationships with suppliers in other contexts, whereas the participants' comparator is closely-knit village life. A close but informal, horizontal, cooperative arrangement was in evidence between P4 and P6, who pooled booking information received from TO2, which increased market access for both firms (Larson, 1992). P4 suggested that the other firms saw business as a winner-takes-all competition, and lacked the vision or the trust to engage in cooperation. Trust will be discussed in section 6.4.1.

The absence of internalisation is consistent with the transactions' not being characterised by specificity or frequency (Williamson, 1985), and with the firms' shortage of financial resources to fund a takeover (Granovetter, 1985) – this was beyond the scope of even the longest-established and best-equipped guesthouses. Furthermore, the firms appear not to perceive a pressure to increase efficiency through internalisation (Granovetter, 1985): P6 expressed deep satisfaction at having built up her firm from scratch and had no inclination to take over someone else's firm to improve performance, suggesting a preference for organic growth. Overseas tour operators are deterred from internalising guesthouses by uncertain property rights, limits on foreign investment and the trend in tourism practice away from direct ownership (Dunning and McQueen, 1981). However, cooperative alliances would be expected, given the shortage of resources (Oviatt and McDougall, 2005) and the opportunism, uncertainty and bounded rationality experienced by these small firms (Nooteboom, 1993). Their absence merits further investigation, as the high transaction costs suggest that these transactions would be more economically placed within a hierarchy or alliance (Douma and Schreuder, 1991), when in fact they continue to be placed in (a trusted segment of) the market.

A distinction that may be worth making, is between the theoretical expectation that firms will actively extend their boundaries by choosing to bring formerly market-based transactions in-house, in rational response to the high transaction costs of an imperfect market (Buckley and Casson, 2009), and those of the firms participating in this study who have always performed a wide range of activities internally. Having converted their farmhouses into guesthouses, many of these firms have elected to continue with their own agricultural production rather than buying produce in, and some have begun to offer additional services internally (such as guiding or running a small shop) as part of the guesthouse. This behaviour has also been observed in large, state-owned hotels in the provincial capital of Kunming, whose range of guest

services are all still performed in-house rather than contracted out. Although these firms have drawn their boundaries where the benefits of internal activities are perceived to be greater than the alternative purchase and transaction costs, and so succeed in bypassing an imperfect market, this does not “bring under common ownership and control the activities which are linked by the market” (Buckley and Casson, 1976: 33), as would occur in internalisation. This is rather an indication of their decision not to specialise.

6.2.3 Specialisation

All but four cases were engaged in a wide range of productive activities, continuing to farm their land in addition to running their tourism enterprise. P2, P3, P11, P12 and P13 were almost self-sufficient for food inputs and labour, suggesting already that they would have little need of external suppliers. P5, P6, P7 and P10 bought in a few goods or specialist labourers such as electricians: these are large and mostly successful guesthouses, some on the road and some more remote, showing that reluctance to procure from outside was not simply dictated by low income or inaccessibility. P14 had specialised out of farming, but held two paid jobs in addition to running the guesthouse. The specialists were P16, whose farm work was all contracted out, and P1 and P4, who were the only firms that had no history of farming; these three only performed tasks directly related to the tourism services they offered. The boundaries of P14 and P16 have undergone the most change, as following their withdrawal from farming they now buy in all necessary supplies. P5 and P13 have altered the balance of time they spend on farming and running their guesthouses, but the scope of activities is unchanged.

P10’s high degree of self-reliance was intended to avoid the risk of depending on market supply (Buckley and Casson, 1998), and this was confirmed in a cross-check between questions by her assertion that this practice would not change even if

production costs rose or purchase prices fell (Lyons, 1995) – the proprietor laughed at the suggestion that her thriving firm might not be able to afford to purchase its inputs. P5 and P13 were also concerned with the risk of low quality rather than the cost of bought-in supplies, indicating opportunism as a factor here too. In contrast P2, P3, P6 and P12 simply had insufficient cash incomes and had to produce their own, demonstrating tighter constraints on their options than transaction costs can account for. P7 also justified in-house production because purchase costs could never be less than his own production costs, but perhaps had the freedom to choose as he was able to keep his three children in full-time education. Risk was not a concern of P14 and P16 in abandoning farming and committing to buying in all future supplies: they both explained the high opportunity cost of farming with reference to the far higher margin they could earn on their specialist occupations. In the terms used by Stigler (1951), they specialised in tasks with increasing returns, leaving co-located farmers to continue the tasks with constant or diminishing returns. P14's motivation thus turned out to be very different than the author had thought during the exploratory study, when she thought the choice not to grow his own food might be due to a lack of kin to supply labour. The contrast is interesting, between current farmers who perceive a high cost of buying in, and ex-farmers who consider agriculture to be a waste of their time and skills.

The uncertain environment drove P5, P7 and P10 to avoid exclusive specialisation in their guesthouses (North, 1990), so that they could revert to farming if tourism demand were to dry up. TO2's ground manager had expected that this would apply to all of the farming firms, but his tour leader thought that the failure implied by closing a guesthouse would make this a last resort. P6, P11, P12, P13 and P14 described non-specialisation as a way of maintaining flexibility, allowing them to reallocate labour whilst maintaining both farming and tourism activities. Only P2 and P3 said that their non-specialisation was dictated by low demand (Stigler, 1951), which meant

that the income generated from the guesthouses could not support the proprietors' families and had to be supplemented by continued farming. The author suspects this also to be the underlying reason for P12's non-specialisation: her fieldnotes describe P12's activities as being "more like two complementary forms of under-employment, rather than a diversification of business activities".

Multiple incomes were used as a livelihood strategy (Ellis and Biggs, 2001) by P2 (who had two jobs, also in tourism but for unrelated pools of clients), P11 (with a second tourism job and a family member working independently in Zhongdian), P13 (with a teacher's salary and a taxi business), and P14 (also operating a taxi and further working as a driver for tour operators and for the firm operating the tungsten mine). P3, P5, P6, P7, P10 and P12 had potential income streams from both tourism and farming, whilst P1, P4 and P16 felt the return from specialisation compensated for the risk of depending on a single income source.

Although the non-specialists are largely self-sufficient, P10 and P13 are non-specialists and are also well-integrated into the client market (as will be discussed in section 6.2.4). Their supply-side isolation, attributed above to the risk of supplier opportunism and the need for flexibility in the uncertain environment, has not prevented them from successfully attracting customers. In these cases, especially P13, which is a small firm, viable businesses are hindered from participating in the supply network by transaction costs. In contrast, those who have specialised out of farming have no intention of re-internalising farm production, perceiving the transaction costs of procurement to be offset by the productivity gains of specialisation. For the specialists with no history of farming, internalisation would require them to take over the farms that are their suppliers. As will be discussed in section 6.3.3, the farmers do not have the right to sell the land they farm, so the closest option would perhaps be for the guesthouses to sign a long-term, exclusive

supply contract with them – and the transaction costs of contracting in this context have already been found to be excessively high. The intervention of formal institutions between transaction costs and anticipated responses therefore continues to merit attention.

6.2.4 Isolation

The concept of integration into or isolation from trading networks was addressed by examining each participating firm's relationships with their customers, suppliers and neighbouring guesthouses.

The number of suppliers varied widely between participants (North, 1990). At the extreme, P12 bought from just one regular supplier in an attempt to reduce the risk of supply: this supplier had agreed to take responsibility if a guest were to fall ill after dining at the guesthouse. The proprietor valued this perceived reduction in risk very highly, even if it seemed doubtful to the author that this could be enforced or blame could be attributed, as bought-in and home-grown supplies are cooked together in the same chaotic kitchen. P3 and P7 always bought from the same limited circle of trusted suppliers in Qiaotou, whereas P2, P5, P6, P10, P11 and P13 shopped across the Qiaotou market. The widest trading was exhibited by P1, P4, P14 and P16, who were integrated into a dense network of supplier relationships extending to Qiaotou, and beyond to Lijiang and Zhongdian for goods not available locally. The contrast between P12's very limited trading despite good road access and P6's wider trading circle coupled with more difficult access to the high path, shows that supplier isolation is not simply determined by inaccessibility.

The frequency with which purchases were made appeared not to depend on the supplier relationships, so much as on the number of guests in residence at any given time, and the carrying capacity of transport used – when rain washes out the access

tracks to the guesthouses on the high path, the staff revert to carrying supplies in from the road.

The duration of trading relationships was important, suggesting that there might be a reliance on informal sanctions that would be effective in personal exchange (North, 1990). P2, P3, P6, P7, P10, P12, P14 and P16 all restricted their purchases to suppliers they knew personally, to avoid the risks of cheating and low quality. This group included large, established firms with many suppliers as well as small or struggling firms, indicating that some conducted trust-based exchange (Zhou and Poppo, 2008) by choice and were not restricted to it by their size or resources. Trading was confined to the same ethnic group by P11, which allows her to buy from people she does not know personally, but she can rely on them being known to others and so deterred from cheating. P1 and P2 purchase mostly from known suppliers but are willing to buy from unknown traders if the need arises; only P5 and P13 expressed a straightforward acceptance of impersonal trade. All participants except P11 and P13 expected to trade with the same suppliers again in the future, supporting Poppo and Zenger's (2002) emphasis on a long-term orientation. This confinement of supply relationships to long-standing contacts hindered business integration and contributed to the isolation of the least-specialised firms. Only a small minority of participants was prepared to conduct impersonal trade, and these firms have emerged as specialist service-providers, deeply integrated into a local supply network.

Customer relationships are focused on tour operators, as passing trade is usually limited to one-off visitors with whom no relationship exists. P2, P3, P11 and P12 have limited commercial success, attracting little passing trade and no tour operators, whilst P1 has a high volume of passing trade but again no tour operators. P2 and P3 are disadvantaged by their locations set back from the tourist path, but the others are sited on the road, close to other successful firms, so their weak performance cannot

simply be attributed to location or remoteness (Rodrik et al., 2004). P16 had just started working with tour operators in 2008, whilst P7 and P14 were seeing a decline in the number of tour groups they hosted. P4, P5, P6, P10 and P13 attracted both tour groups and passing trade. P5 explained the attraction of tour operators as a source of high volume, repeat trade. He found the groups very easy to look after with homogenous requirements, and he emphasised the importance of regular contact with the operators to maintain numbers. The aim of a client relationship was thus maintenance of demand, rather than trust-based exchange.

As described above, pooling of information between P4 and P6 was the closest approximation to a cooperative alliance in lieu of internalisation (Artz and Brush, 2000). Other forms were not reciprocal: P1 would refer customers on to other guest houses and telephone ahead for them, whilst the display of publicity materials (by P4 for the non-participating guesthouse, by P6 for P5, by P12 for P6; P3 mistakenly believed that P4 displayed a map showing her guesthouse) was not equivalent to the cross-marketing observed in the urban sites of the exploratory study. P12 and P16 explained that making recommendations would put their own reputation at risk, in the event that the client disliked the recommended firm and felt cheated. In 2007, P7 had said that he cross-referred customers with the non-participating interviewee, but in 2008 – like the remainder of the participants – he no longer made recommendations.

6.2.5 Refining the concept of isolation to answer research question 2

In refining the concept of isolation, the author incorporated all elements of the value chain that are connected to the participating firms. These included supplier relationships (integration up the value chain), customer relationships (down the chain), inter-guesthouse relationships (along the chain), and personal exchange as a potential constraint on each of these links in the chain. All of these were of concern

to the participants and have shown variation within and between firms – illustrated most strongly by P13 – and so all four were incorporated into the scoring of the outcome variable, using benchmarks derived from the literature, as will be explained in the Data Reduction section of Chapter 7.

The other forms of response to transaction costs were not directly included in the coding of the outcome. In the cases of contract, pure market transactions and internalisation incorporating a change of ownership, the field study simply confirmed that these responses were minimally or not present. Other transaction cost responses were more relevant, and the features that were present are reflected in the outcome, and contribute to our understanding of it. For example, where questions on governance showed relational trading, this is addressed by the outcome of personal exchange; organisation structures incorporating an element of cooperation were reflected in the outcome of inter-guesthouse relationships; low internalisation meant that most firms did not specialise, and the related limited trading is shown in the outcome for supplier relationships.

Consideration has also been given as to whether the direction of causality could in fact run the other way – whether this kind of isolation could be a cause of rather than a response to transaction costs. This cannot be the case for specificity or frequency, which are characteristics of the transaction itself and so cannot be caused by withdrawal from trading. Nor can this work for uncertainty, which is a feature of the external environment that affects – rather than being affected by – the actors and their actions in that environment. It might be said that bounded rationality and opportunism could increase for an actor who was isolated from trading and lost touch with market conditions and practices, but when bounded rationality and opportunism are considered as causes of transaction costs, it does not make sense that an actor's avoidance of transactions has the effect of increasing the cost of those transactions.

These findings answer the second research question: isolation is the principal response to transaction costs, being evident in the structures, activities and relationships of many participating firms, followed by cooperation. The implication is that this study will contribute to filling the first gap in the literature, concerning isolation as a little-researched response, and the task of the analysis will therefore be to explore whether common combinations of transaction costs are perceived by isolated firms. As the response of isolation is not the predicted response to the causes of transaction costs that are present in the research site, other potential causes should be taken into account, so we proceed with the third research question.

6.3 Formal institutions

This section discusses how the participating firms perceived formal institutions to affect the level of transaction costs, and to shape their responses to these costs. All of the participating firms were registered, so the nature of the institutions had not prevented them from joining the formal economy, as feared by Cleaver (2007). The author also conducted context interviews on these topics with government, financial and legal bodies, to broaden her understanding of the issues raised by the participants, and to confirm the participants' interpretation of relatively complex issues.

6.3.1 Local government

The local government bodies were (in descending order of seniority) Yunnan Province, Diqing Tibetan Autonomous Region, Zhongdian County, Qiaotou and Haba townships, and individual village councils. Of these, the townships were the bodies that most influenced the firms' operations, with villages simply organising work-teams for tasks such as the maintenance of roads and drainage channels – this impacted the staffing of P16 during a visit by the author.

The author was aware that discussing the government might put participants at risk, and so took care to ask the questions in neutral language, and did not press participants to answer questions they avoided in this area. This led to incomplete responses in some cases, but the insights obtained are considered by the author to be valuable and probably rare.

P10, P12 and P13 considered local government to have a positive effect on their firms, with P13 giving the example of a good environment for entrepreneurship in which competitive firms would succeed. P3, P4, P6, P7, P11, P14 and P16 considered local government not to harm their operations, but P1 qualified this by saying that no harm was done if taxes were paid and rules obeyed. No participants described it as having a strong negative impact (Zhou and Poppo, 2008, Peng, 2004), and P11 went so far as to volunteer the statement that “the government doesn’t steal our money”. P2 and P5 had no opinion, positive or negative of a government that seemed remote to their daily concerns, supporting Levitsky (1989).

No participants reported receiving financial support, confirming Luo’s (1997) fears, and perceptions of the tax burden varied. An urban participant found it high whilst P3, P5 and P13 said their tax bills had fallen, reflecting the abolition of the largely regressive agricultural taxes and fees in 2006, which had previously consumed 15% of average rural income or 17% for the poorest quintile (OECD, 2010). None were aware of any enterprise support (Elkan, 1995), which the Small Enterprise Service Division (that supports the development of local small and medium enterprises, or SMEs) of the Chengdu Municipal Economic Commission had advised the author was available from the SME division of the Diqing Economy and Trade Committee. But despite Mair and Marti’s (2007) suggestion that this minimal level of institutional support might contribute to the limited market participation by some firms, P12’s decline was not being stopped by the beneficial effect she claimed the government

had on her firm, and although the market participation of P2, P3 and P11 was very limited, they did not attribute this to failure on the government's part.

Half of the six participants expressing an opinion found local government inefficient or inept (Rao, 2003). P4 described the time-consuming task of chasing the local tax officer to send her a bill, knowing from past experience that non-receipt of a tax bill was not considered to be a valid reason for failing to pay it.

The author was able to code ten responses to Child and Moellering's (2003) question of confidence in officials' honesty. This drew on interview questions directly concerning government and on broader questions of whom the participants could trust. The author interpreted responses to indicate less trust where there were tensions between responses by the same participant (P16 answered a broad question with the statement, "Naturally we can trust the Communist Party", but was less emphatic when asked directly about the government) or body language that contradicted a positive spoken answer (observed for P6). P1, P4, P10 and P12 expressed some confidence in local government, outweighed by P6, P7, P11, P13, P14 and P16 stating or suggesting distrust. Only one interviewee used the word "corrupt" to describe the government.

Just two (P7 and P11) out of ten participants found it difficult to understand or comply with local regulations (Child and Moellering, 2003), and three (P1, P4 and P7) out of eight found it difficult to stay up to date with changes to regulations.

Five out of ten participants perceived unfairness by local officials, and three of these felt it hindered the development of their business. One of these, P7, felt powerless to defend his firm, whereas P1 used *guanxi* for protection as expected by Peng (2004). Peng's idea of predation was illustrated, albeit by national government, by a claim that the Beijing government blocked websites so regularly that the proprietor was

forced to post advertisements for his guesthouse on four separate websites in the hope that at least one of them would be available at any given time.

Similar issues had been reported by the foreign-invested firms (FIEs) interviewed by the author in Chengdu in 2006: two struggled to keep up with regulatory changes, one found the local government unfair unless persuaded to behave otherwise with gifts, and one judged the bureaucracy in Yunnan to be more inefficient than that in Chengdu. Mixed opinions were held as to the quality of service offered by the local tax office. In 2008 a newly-established FIE reported that regulations and tax still took up much of the small firm's time, and that it received no support. The Small Enterprise Service director claimed that the constraints on small firm development by multiple regulations were being reduced, and that regulations were readily available (to Chinese and foreign firms) on the internet. He was surprised to be asked about firms too small or remote to have internet access, but thought they could see policy announcements in the press. He also explained that SMEs would only be paid compensation for compulsory relocation if they owned their land, and he acknowledged that few did.

6.3.2 Funding

P2, P3, P6, P7, P11 and P13 reported that they were unable to borrow from banks, as anticipated by Elkan (1995) and Peng (2004), and P4 and P10 had not tried. P1, P5, P12 and P14 reported great difficulty in securing bank funds, and only P16 had borrowed without difficulty. Some thought it would not be possible to borrow sufficient sums to fund extensions to accommodation (P1, P2, P11 and P13).

The difficulty or impossibility of formal borrowing was widely attributed to the banks' procedures for securing loans – except by P11, who was the only participant to express concern as to how she would repay any loan. The use of guesthouse

buildings as collateral worked only for P1 and P16, both of which are urban sites not subject to rural land-use restrictions. The rural participants' property rights allow them to build but not to secure loans on the collectively-owned land they occupy (Bai et al., 2006, Cleaver, 2007)³, so the only alternative security is a personal guarantor who deposits a sum equivalent to the loan with the lending bank, for the full period of the loan. This procedure was widely understood, being cited by P2, P5, P6, P11, P12, P13 and P14, although none had access to such a guarantor. The Branch Manager of a foreign-owned bank in Chengdu, interviewed by the author in 2008, confirmed that Chinese banks require guarantors and acknowledged that in these cases the banks add no value. He reported that his had been the first bank, and was still the only foreign bank, to offer loans to local, private SMEs from 2004, but it has no representatives in Yunnan yet and does not serve the rural market. His bank offers unsecured loans, because SMEs often lack assets to offer as security: he denied that property rights were the issue. The principal impediment to SME lending (above availability of capital) was lack of reliable financial information on potential borrowers (Poutziouris et al., 2002), for which his bank compensates with a labour-intensive search for complementary "soft information" by relationship managers. The bank considers this a sufficient basis for lending to hand-picked clients who cannot offer the security demanded by other banks (who also lack client financials) – their dependence on personal guarantee, based on a trust relationship with SME board members, demonstrates the vital importance of personal trust even in the most

³ Following the author's most recent field visit, she heard from a contact in a Chengdu law firm that the Chengdu Municipal Government had just adopted a policy recognising title and so enabling the mortgage and sale of rural housing, with the intention of speeding up reconstruction following the earthquake. It was expected that this would serve as a pilot after which it might be applied across China, but the author cannot verify whether or not this has happened.

formal of organisations. The manager confirmed that small firms' borrowing costs were high, and the alternatives were informal borrowings or "underground" lenders who sell on funds obtained as personal bank loans. Local banks, such as the Qiaotou branch of the Agricultural Bank, are supposed to lend to SMEs but lack the requisite information to reduce risks, and so fear increasing their stock of non-performing loans – illustrating the conflicting government instructions described by Herd et al. (2010).

The Chengdu Small Enterprise Service director recognised that small firms were constrained by their inability to borrow, and that this in turn was due to their lack of mortgageable assets. His organisation attempted to make up for this by offering credit guarantees of their own, although if it were instead to formalise the provision of financial information to market lenders, it could contribute to correcting the root cause of this market failure (Herd et al., 2010).

As formal borrowing was inaccessible to most participants, the interest rates and repayment terms were not a key concern to them. This led some to imagine that they wanted to borrow amounts that appeared risky to the author: P2, P11 and P13 thought they would need RMB 30k-50k to build en-suite extensions, with the capital alone equating to at least 2-3 years' total income for an unskilled labourer earning RMB 50 per day. P1 expressed frustration that the sum borrowed could not exceed the value of the property posted as security, causing the author to consider that the shortage of lending may in fact have had a positive effect in constraining irresponsible lending, particularly in the light of the banking crisis that was just unfolding at the time of the 2008 field study.

Peng's (2004) expectation is partially borne out, with all but three participants having access to informal lending by family or friends. However, the participants had a higher degree of reliance on reinvesting profits than had been suggested by the

literature: the available volume of informal borrowing simply could not meet the participants' demand for investment in extensions and upgrades to accommodation. P7's extensions had all been funded through retained profits, as had P16's until the hospitalisation of a family member in late 2007 consumed his savings and informal sources, such that in 2008 he reported bank loans for the first time. P1, P3, P13 and P14 intend to reinvest profits once their firms are earning a significant return. Only P11 receives a remittance from a migrant worker (Elkan, 1995).

A further potential source of financial support would be the proceeds of the road toll charged to all users of the gorge road, including trekkers. Neither the toll-booth staff nor most of the local guesthouse owners have been able to explain to the author who charges the money or on what it is spent. P4's report is supported by Donaldson (2007): the private firm, owned by Li Xiaopeng (son of the former Premier, Li Peng), that bought the tungsten mine in 2002 charges the fee and is expected to maintain the road in return, but P4 does not know who charged the fees prior to 2002. The funds are apparently not reinvested in local development, as the participants are unaware of this and section 6.3.3 shows it does not compensate for environmental damage. As the number of toll tickets sold is not controlled, it is not a check against estimated carrying capacity of the site, so even the administration of toll charges does not have an environmental benefit. Finally, P4 and P7 fear that the toll charge deters potential visitors.

As a result of this funding constraint, P2 and P3 had insufficient working capital to put up signs advertising their participation in the market (Mair and Marti, 2007), P11 and P12 could not invest in any upgrades to facilities, and P1, P6 and P13 perceived it as a constraint on the growth of their firms. Only four interviewees routinely made purchases on credit, and only four were satisfied with the level of cover of their buildings insurance.

6.3.3 Legal

Six of the interviewees reported a significant cost (either financial or in terms of administration time) of maintaining their company registration (Cleaver, 2007), and two of these (P6 and P13) felt this brought no benefit to them beyond legal compliance. In contrast, P16 considered the cost to be negligible and to be outweighed by the benefits of reduced liability.

P2, P3, P6, P7, P11 and P12 all avoided impersonal trade because they were not confident of legal protection (Zhou and Poppo, 2008). P1, P4 and P14 also doubted the effectiveness of protection, but traded despite this. Only P5, P10, P13 and P16 felt that they could rely on the law to protect their interests in impersonal trading (North, 2003).

Of the eight participants who acknowledged the risk of opportunism, P4 and P7 would have no faith in legal redress and would seek informal resolution if cheated (Luo, 2007), and P11, P12, P14 and P16 would attempt informal resolution first (Zhou and Poppo, 2008). However, P11 feared that she would be unable to afford the attendance fee that the police usually charged: the context interview with a Chengdu law firm confirmed that there was no legitimate reason why the police should charge fees. P6 and P13 would confidently take legal action, and P1 would take it but without confidence of success. When asked about resolving disputes rather than cheating, only P11 would consider legal action; the others would use informal methods in preference or exclusively – suggesting the importance of mediation to preserve relational trading, unless trust were broken by cheating. The Chengdu solicitor explained that Chinese people were more accustomed to informal than legal resolution, confirming North's (1994b) view that change of formal institutions can happen more quickly than informal, and in her opinion social pressure was more effective than the law in deterring opportunism.

In terms of the capacity of the legal system for overall risk reduction, P4, P7 and P11 did not feel that it reduced the risks of opportunism or uncertainty (North, 2003, Cleaver, 2007). P6, P14 and P16 acknowledged some reduction, with P6 adding her own judgment of character to reduce risks of opportunism. P1 and P5 distinguished between effective risk reduction for opportunism, and ineffective reduction of uncertainty.

Property rights were readily understood in the context of the planned dam, with expressed views of the risk evenly split. Half of the participants were confident, feeling their rights were secure (P2 and P16) or that compensation would be sufficient to re-establish a business (P1, P6 and P12), whilst the other half (P5, P7, P10, P11 and P14) anticipated expropriation without adequate compensation. Only P4 and the tour operators avoided investing in property for fear of expropriation (Bai et al., 2006, Khanna, 2007). The solicitor thought that in the vast majority of cases of expropriation in the public interest (where the definition of “public interest” was a controversial issue), compensation was insufficient to buy an equivalent new home, and the only other course of action was to accept alternative accommodation of unspecified quality and location.

Although only P1 had direct experience of contracts, twice as many participants thought contracts could be enforced than thought they could not (P7, P10 and P16) (North, 1994a). This inexperience precluded them from knowledge of enforcement costs (Hoskisson et al., 2000), or of the procedural steps required for drafting and enforcement. None, however, would consider contracting with someone they did not already trust (Zhou and Poppo, 2008). This was perhaps just as well, since the Chengdu solicitor advised the author that incorrectly drawn contracts would not be legally binding, and enforcing out of court would be far more economical than pursuing a civil action. She felt that an impediment to legal enforcement was rural

people's lack of knowledge about the law, and the (affordable) services offered by solicitors.

Externalities were discussed in terms of the pollution and environmental damage caused by tungsten mining above the gorge (Milgrom and Roberts, 1992). All participants were aware of it, except four who were sited on the road rather than the high path. Five participants (P3, P4, P7, P13 and P14) experienced consequent costs of reduced trade or seeking a new water supply that were neither prevented nor compensated by the environmental protection authority (Rao, 2003). The problem appears to have worsened over time, as respondents who had been unaware of it in 2007 reported costs in 2008. In contrast, nine participants contributed financially towards compliance with environmental protection measures.

The low confidence of participants in legal protection, and their inclination to seek supplementary or alternative protection by informal means, confirms the need to continue with an examination of their perception of informal institutions. To conclude our discussion of formal institutions, it appears that the problems are caused by the absence of institutions. Legal shortcomings are due to a lack of legal enforcement, rather than necessarily being due to problems with the law itself. The local government appears not to do harm, but government support could perhaps have a beneficial effect; the same applies to the lack of funding. The formal institutions appear to be weak, rather than strong and harmful.

6.4 Informal institutions

6.4.1 Trust

Interpersonal trust was commonly restricted to family and close friends or long-standing social contacts (P3, P6, P7, P12, P14, P16) (Child and Moellering, 2003),

although P10 and P13 would extend this trust to individuals introduced to them by such social contacts – relying still on acquaintance rather than description (de Soto, 2006). Trust was never confined to family alone, which Fukuyama (1995) and Peng (2004) anticipated. Beyond the social network, business contacts of long duration were trusted by P2, P5 and P11, and recent business contacts by just P1 and P4 (Granovetter, 1973). The urban participants tended to display more flexibility in categorising who they would trust.

Trust appeared not to be generalised (Knight, 2001), as it was in part tied to individuals or reputations within the social group (see section 6.4.4 for discussion of reputations). Nine participants were likely to trust people they perceived to be similar to themselves, limiting the scope for complementary economic benefits (Lewicki and Bunker, 1996) and contributing to the feeling of a small gene-pool – even for P1 who had seemed very flexible in the first question. This idea was readily understood, suggesting it approximated very closely to participants' conceptions of trust, and it corresponded to earlier responses that favoured trade with members of the same ethnic group.

Impersonal trust (Humphrey and Schmitz, 1998) was present for eight participants (P1, P4, P5, P10, P11, P12, P13 and P16), but was often limited to specified firms or institutions. Only P5 and P13 exercised this trust by conducting impersonal exchange (Rao, 2003). Minimal trust for simple trades was far more common (eight participants) than extended trust for long-term planning (Humphrey and Schmitz, 1998). Only P4, P5, P6, P7 and P13 exhibited the latter in terms of cooperation with foreign tour operators, but it was never contractual.

Barney and Hansen's (1994) typology of trust appeared not to be appropriate to the context, and was excluded from coding. Rather like earlier questions about fear of opportunism, most respondents claimed not to have any vulnerabilities and so

indicated weak trust. However, this was not because of perceived invulnerability so much as because they already had safeguards (such as personal trading) in place. The theory expects to describe confidence in the protection of acknowledged vulnerability as semi-strong or strong trust.

Ten participants stated that a trust relationship had to precede business transactions (Zhou and Poppo, 2008), and only P4, P5 and P13 used small-volume, low-value trades to develop trust (Lewicki and Bunker, 1996). No respondents reported a relationship that had survived a cessation in trading, contrary to the expectation of Dibben and Harris (2001), but trading had ceased either because of cheating which terminated the trust relationship, or because of a change in circumstances unrelated to the relationship. Dispositional trust (P7, 11, 14 and 16) was not associated with willingness to conduct impersonal exchange, supporting Hardin's (2001) view that in isolation it has little effect.

Interpersonal trust was effective in reducing the expectation of opportunism (Steensma et al., 2000): of the ten participants acknowledging a risk of opportunism, four (P1, P3, P11 and P13) felt that trust could reduce this risk, and trust removed the risk for the other six (P2, P5, P6, P7, P10 and P16). This supports the views of McDonald and Vertova (2002) and Buckley (2004) that social networks can increase trust, but the author considers this effect to be of finite benefit because – as warned by Storper (1991) and Keister (2001) – it restricts trade to a pool of trusted counterparties that can only be extended over a long time period. This restriction could be rooted in the undermining of social interaction by the enforced dependence on centralised formal institutions (Knight, 2001) during China's Cultural Revolution (1966-76), which has yet to be repaired. However, although history is “a very important conditioning feature in the background context [that can provide] some

sense of the trajectory of development along which an economic system may be seen as evolving” (Redding, 2005), it is not our main concern in this study.

6.4.2 Kinship

Kinship was an absolute condition for employment by P6, P12 and P13, which was relaxed to include members of the social network by P1, P7, P10 and P16. Only four of the 11 participants who were not sole traders would consider drawing employees from outside the social network. Purchasing was also affected by the extent of the network, with half of the participants preferring to trade within it. This suggests that the constraint on the growth of the participating firms was not composed exclusively of kinship, which was expected by Fukuyama (1995) and Whyte (1996), but by a less sharply defined constellation of kinship and social ties as described by Peng (2004). As an example of the time taken to build up these ties, the co-proprietor at P13 still feels a relative outsider in the gorge even though she moved there in 1990 and the family set up the firm in 2006. A beneficial effect of network-based recruiting can be seen by comparing P16 with guesthouses in the Yubeng valley (mentioned in Chapter 1 as a possible field site). Both employ large numbers of horsemen on a casual basis, to escort tourists on pony-treks. As P16 recruits them from his social network, this provides occasional paid employment to local residents. In contrast, the Yubeng tourism services have far outgrown the capacity of the local workforce, and now pull in large numbers of young men from further afield who have no connection to Yubeng, and nothing to do or anywhere to go after stabling the horses in the evenings.

P13 and P14 report some protection from opportunism through kinship ties (Peng, 2004), and P1, P5, P6, P10 and P16 group family and friends together as a single source of protection. The remaining participants were entirely self reliant regarding the threat of opportunism. No participants sought help from their families for dispute

resolution. Of the participants who have had disputes, P1, P6 and P14 would attempt resolution by friends, and they confirm Peng's (2004) view that this avoids transaction costs (understood as expense or delay) of enforcement but with less reliable effectiveness. P5, P7, P11, P12, P13 and P16 would not involve family or friends at all.

6.4.3 Wider networks

Hu's (2007) term "*guanxi* community" reflects the participants' habit of drawing on a social network extending beyond the family. For P1, P5, P7 and P10 the network serves business and social purposes, but P12, P13 and P14 maintain a distinction between business and social contacts (Li et al., 2008b).

Structuring the business around this network is common practice, with the majority of participants accustomed to trading within it (Zhou and Poppo, 2008). Only P4 and P5 routinely trade outside their networks, and P1, P13 and P14 appear to be in transition as they occasionally trade outside their usual group. This latter grouping of participants is composed of urban and long-established firms.

All but P6 and P10 considered the time-investment to maintain these networks to be insignificant (counter to the expectations of Peng (2004) and Douma and Schreuder (2008)), or easily outweighed by the competitive advantage inherent in an established network. P2 and P3 felt confined to trading within their network because of their dependence on the integral trust-relationships, supporting Child and Moellering (2003), whilst P6 and P10 acknowledged this constraint but placed a higher value on the protection from opportunism that it offers. The remaining participants felt able to extend the boundaries over time or to seek opportunities outside the network, showing less restriction than Poppo and Zenger (2002) had anticipated.

P2, P3, P11 and P12 were examples of Keister's (2001) concern for path-dependence: all four firms considered themselves to be at a competitive disadvantage due to their limited networks, such that none of them described their firm as growing or as having had a notable growth phase. This could not be attributed simply to location (two were on the road, two were not), ethnicity (which varied), the founder's recent arrival in the locale (three were resident farmers before opening guesthouses, the other had moved in seven years earlier), or youth of the firm (three were as old as P6, who had laid foundations for the first set of extensions by the time of the author's first visit five years after its founding). For other reasons, they had simply failed to gain entry to a network. P1 and P13 expected to overcome this disadvantage over time, or by compensating for a lack of local contacts by increased contact with non-locals. P6 was an exception to Whyte's (1996) expectation: she compared her firm to P7, pointing out that it was ten years older and bigger than her firm, but claiming that hers was performing much better in spite of this and that her less-established network did not hinder her from competing successfully. The remaining participants were the longest-established firms, all acknowledging that their networks were a competitive advantage, except P5, who denied it was an advantage and suggested that the younger firms ought to show some spirit and build up their networks – much as P6 has done.

The participants differentiated clearly between their social or business ties and political connections (Peng and Luo, 2000), with only P1, P4 and P11 claiming to have any political *guanxi* (Li et al., 2008b). This appears to be a characteristic of the research site, as the author has confirmed the literature's expectation of the need for such ties in the cities of Chengdu (where multiple FIEs stated that government *guanxi* were vital, with two specifying their importance for start-up firms) and Dali (where a Chinese tourism entrepreneur used them to circumvent the bureaucracy on behalf of his clients). There were no reports of *guanxi* being used in defence against

officials (Xin and Pearce, 1996). Some participants considered *guanxi* to be an unfair source of competitive advantage that their small firms could not access – but one of the three firms condoning it as the local way of doing business, was a small and simple guesthouse that still felt able to make useful connections. Strongly negative views of the practice were expressed, as anticipated by Guthrie (1998) and Luo (2008), by P3, P5, P12, P13, P14 and P16 – using the terms “deception”, “cheating”, “low integrity” and “not virtuous” – and with P5 adding that he wanted to avoid owing anyone any favours. The other participants preferred not to engage in *guanxi* practices, but refrained from judging those who did. Exclusion from or denunciation of *guanxi* practices were not associated with common ethnic groups or urban/ rural locations, and the generally low importance of *guanxi* may be attributable to the distance of the research site to any bases of significant political power.

6.4.4 Social sanctions

This topic turned out to be a poor fit with the research context, despite Peng’s (2004) assertion that protecting one’s reputation is an effective deterrent to dishonesty in China. P3, P6 and P7 insisted there was no need for a deterrent as there was no dishonesty, yet all three had reported the presence of opportunism in earlier questions. This inconsistency in the data, and the lack of variation in the responses (all the remaining participants except P1 considering that other mechanisms, such as family pressure or village norms, were adequate) caused the author to omit this topic from the later iterations of the fsQCA analysis (see Chapter 7). Again, the premise that societies will establish systems of sanctions if they expect dishonesty (Humphrey and Schmitz, 1998) trips up in a context where individuals have already shielded themselves through personal trading, and so no longer feel the need for protection by sanctions.

However, the author does not suggest that the participants considered their reputations unimportant. On the contrary, they reported setting great store by their own good reputations. The issue was that only half of the participants thought that communicating changes to other people's reputations (to make the deterrent credible, Douma and Schreuder (2008)) could actually happen – two implied that the reputation of the communicator would be damaged in the process of telling tales. Since this results in relatively static reputations, trust attaches to personal knowledge of the individual rather than their reputation. Despite this, all but P4, P12 and P14 expressed a preference for trading with counterparties of known reputation, reducing the number of trading partners as feared by Keister (2001).

6.4.5 Empirical study of informal institutions in the research context

The second gap in the literature that this study aimed to address was a lack of empirical research on informal institutions in China. This study has found trust, and the social structures within which trust develops, to be crucial in enabling and safeguarding transactions. The drawback, however, is that only insiders can benefit and it takes a long time for an outsider to gain admittance – if they do at all. Although the presence of trust can be effective in reducing transaction costs in this context as anticipated by Hu (2007) and enable cooperation, the scarce supply of trust in this research context hindered cooperation and raised the transaction costs of establishing trust. The slow and deliberate development of trust before transactions commence is intended to reduce the risk of opportunism. As such, its development represents a transaction cost just as the reduction of opportunism through detailed contracts or internalisation would.

Participants did not consider themselves to be acting against their firms' own interests as a result of informal constraints (Oliver, 1991), but their confinement of trading to the network exposes them to the risk of paying higher prices than might be

available in a more competitive market. This raises the question of what more strongly constitutes the firm's best interests: pursuing best prices on the open market, or being shielded from the risks of that market through reduced trading or isolation. In the absence of more robust formal institutions to protect transacting parties, the latter currently takes higher priority, with the former being less realistic until future institutional reform enables firms to extend into impersonal trade (North, 2003). Under current conditions, however, firms that are established in a network will be freer to trade than the firms outside whose only protection is isolation and, consequently, a continued inability to specialise.

6.4.6 Research question 3

The third question asked whether an appreciation of the institutional context could help to explain firms' responses to transaction costs. Here we offer a preliminary answer, prior to the detailed analysis in fsQCA.

The interview findings support the view of Zhou and Poppo (2008) that transaction cost theory assumes a stronger formal institutional starting-point than is the reality in China, and suggest that this affected firms' responses to transaction costs. Their decisions were steered more by a need to protect their firms from uncertainty, opportunism and the effects of bounded rationality, than by a wish to economise on the costs of specific or repeated transactions. Although they perceived these behaviourally-driven transaction costs, the firms generally responded to them by reducing the number of transactions they conducted, rather than by placing them in a different organisational structure as their response was constrained by the institutional environment.

The anticipated response of increasing the complexity of contracts will remain inapplicable to this research site until such time as the legal infrastructure to support

them may be strengthened, and made available locally. The predicted response of internalisation is made unattractive by uncertain property rights, is not viable due to all firms' lack of resources and access to finance, and is unnecessary in the case of the unspecialised firms whose operations already include food production. The author had considered cooperation to be a more realistic response, but the scope for it is severely limited by the constraint on forming new business relationships, which results from the long-term nature of trust and its roots in kinship and social networks, and the lack of legal protection for parties to transactions. North (1990) also observes that game theory's prediction of cooperation assumes no end-game position, whereas the threatened flooding of the gorge presents such a position.

The hesitation to conduct impersonal exchange, and the self-reliant withdrawal from the market, appear to have evolved as a logical and practical response to the transaction costs of risk in the absence of protection by reliable formal institutions. Whilst this appears to support the idea of institutions affecting the relationship between the causes of and expected responses to transaction costs – relying on informal agreements, lending and dispute resolution to enable firms to respond – the substitution of informal for weak formal institutions was not found to be straightforward. P5 did not know how closely his words echoed those of North (1994a), as he presented his opinion that either formal or informal sanctions would be ineffective in the absence of the other, as formal rules needed informal acceptance and informal sanctions needed to be backed up by formal rules. Trust is not sufficiently widespread in this research context to act as a direct substitute for weak formal governance, as had been suggested by Poppo and Zenger (2002), and informal institutions are filling only some of the gaps left by absent formal institutions (Li et al., 2008b). More resilient informal institutions could address more of these gaps, or alternatively, stronger formal institutions that help to protect transactors from opportunism could act as a functional substitute for trust

(Granovetter, 1985) and so facilitate the integration into the supplier network of firms currently outside it.

6.5 Summary

The thematic analysis has identified the key features of the environment and the effects they have on firms, which are summarised in Table 2 below. This shows the constraint imposed on firms by the high transaction costs of opportunism and bounded rationality, answering the first research question. It shows isolation as a common response to high transaction costs in the second research question, with little trading, cooperation or specialisation. The table also shows weak institutions failing to reduce transaction costs and constraining firms' responses to them. Although this highlights problems with individual features of the trading environment, recommendations for their improvement would be better made on the basis of a consideration of the interactions between the features of the environment as a whole. After the next stage of the analysis has further investigated any relationship between institutions and isolation, Chapter 9 will make such recommendations.

Table 2 Summary of interview findings

Feature	Effect
Transaction costs	Raise the cost of protecting firms
Bounded rationality	Information asymmetry in purchasing
Opportunism	Fear of it prevents impersonal trade
Uncertainty	Very high but does not prevent trading or investment
Specificity	Absent
Frequency	Minimal

Responses	
Transactions	Number minimised, governance more relational than contract or market
Organisation structure	Unitary, little cooperation
Specialisation	Rare. Largely due to fear of opportunism, some due to lack of resources
Isolation	Due to opportunism, prevents wider or impersonal trade and specialisation

Formal institutions	Ineffective, do not reduce transaction costs
Local government	Offers no help, little hindrance
Funding	From informal sources and retained profits
Legal	No reliance on protection

Informal institutions	Important now but difficult to scale up
Trust	Vital, but confined. Only interpersonal, not impersonal
Kinship and networks	Source of trust/ protection, and a constraint. Exclusivity
Sanctions	Absent

In sum, the apparent effect of high transaction costs and weak institutions, is to maintain or contribute to the constraint of personal exchange. This will be expressed as:

High transaction costs and weak institutions → isolation

This expression will be used in Chapter 8, as an ideal type configuration against which to compare the results of the fsQCA analysis.

The effect of institutions in limiting the range of responses available to firms shows that institutions should be incorporated into transaction cost theory, before it can be considered to apply fully in this emerging market context. Furthermore, a more

detailed analysis is required to explore any interactions between transaction costs, responses and institutions. The fsQCA analysis in Chapter 7 will help to unravel the causal complexity to identify whether such causal patterns are present, and which particular conditions appear to be associated. This will contribute to our conceptualisation of how these factors work together as a system, to better identify where the problem lies that we seek to address.

CHAPTER 7 fsQCA ANALYSIS AND FINDINGS

The previous chapter presented a thematic analysis of the interview data, and identified the need for a more sophisticated analysis to interpret the complex causation inherent in answering the third research question. This chapter will begin by describing how the interview data were reduced to six fuzzy sets representing five causal conditions and the outcome condition, and how they were scored for all 13 cases. It will then describe the analysis in fsQCA of this fuzzy set data, with the aim of making the analytical process transparent and offering a rationale for decisions made (Rihoux and Ragin, 2009). To perform an fsQCA analysis, the same series of steps must be repeated in parallel for both the presence of the outcome (being isolation in this study) and for the absence of the outcome (integration into the market), to allow for causal asymmetry. These steps are illustrated in Table 3 below, and reference is made to the section of this chapter in which the step is described.

Table 3 Procedural steps for an fsQCA analysis

For the presence of the outcome:	For the absence of the outcome
Test for necessary conditions (section 7.2.1.1)	Test for necessary conditions (section 7.2.1.2)
Construct a truth table (section 7.2.2.1)	Construct a truth table (section 7.2.2.2)
Analyse the truth table (section 7.2.3.1)	Analyse the truth table (section 7.2.3.2)

This chapter will close with a presentation of the findings of this analysis, which will be discussed in Chapter 8.

7.1 Data reduction

This section explains and illustrates how the interview data were converted into fuzzy set scores, and then further reduced for upload into the fsQCA software.

7.1.1 Transformation from field notes to fuzzy sets

As described in Chapter 5, the interview data were summarised into a Framework grid containing all the participants' responses to all the questions asked, linked back to the literature, and offering clear visibility of all the data. This visibility was important during the transformation of this data from field notes to fuzzy sets, for checking the consistency of responses when a similar issue was raised in different sections of the interview guide, or for cross-referencing responses.

The first pass of coding served first to group together interview questions addressing similar topics from different authors' viewpoints, or questions where responses had little detail for some cases. Rihoux and Ragin anticipate this: "The nature of the evidence is not [always] identical across cases" (2009: 90). As was discussed in Chapter 5, the author ensured uniformity of scoring for each set by specifying qualitative anchors with reference to the literature, setting them to contain only relevant variation, and then adding further incremental scores to reflect the degrees of quantitative variation present in the case data (Ragin, 2000, Ragin, 2008b). This procedure was applied systematically to all the sets in turn.

As an example of the coding process, the set of case firms with an awareness of opportunist behaviour in the research environment (set code TOL1, for **T**ransaction costs, **O**pportunism, topic **L**, sequence **1** – which is included in the list of fuzzy set codes in Appendix 1) was coded as shown in Table 4 below. This uses a five-value scale incorporating two breakpoints derived from the literature, and three incremental points from participants' responses and additional observations by the author.

Table 4 Calibration of the fuzzy set for firms that are aware of opportunism

Value	Criterion	Implication for set membership
0.00	Participant reports that there is no opportunism of any kind.	The firm is not a member of the set.
0.25	Occurs only in exceptional cases by few actors, or a limited number of types are reported.	Weak membership, firm is more out of the set than in it.
0.50	Participant reports that there is no opportunism of any kind, but their observed actions demonstrate that there is.	Point of maximum ambiguity, firm can not be said to be in the set or out of it.
0.75	Opportunism by multiple actors occurs in the normal course of events, it is considered to be usual.	Strong membership, firm is more in the set than out of it.
1.00	Many types of opportunism, by many or almost all actors, occur frequently.	Full membership of the set.

The cases are not only scored relative to each other for their awareness of opportunism, but also within the calibrated bounds of 1 and 0. This makes it possible to distinguish which cases (if any) are in the set that are aware of frequent opportunism (scoring 1), and which are outside it, being qualitatively different in their denial of the presence of opportunism in the research site (scoring 0), without having to derive these positions relative to a sample-specific measure of central tendency such as the mean of a sample (Ragin, 2008b). This process of calibration directly connects the empirical findings to the theory even in the absence of a measurable variable, as the concept of opportunism can be used to define a target set (cases with awareness of opportunism), which is then calibrated for varying degrees of membership, and each case is finally given a membership score within the set. In the paragraphs that follow, detailed examples are given of how indicative sample questions were scored, to make the coding process transparent to the reader (Haegel, 2007).

The upper bound (1) was set where participants identified multiple types of opportunist behaviour, with examples drawn from Williamson (1975) and Schauwecker and Kühmann (2007), and the lower bound (0) was set where these types of behaviour were said to be absent. Further, local examples of opportunist

behaviour given by P4, such as over-charging or selling poor-quality goods, were also incorporated into the scale in an attempt to “operationalise theoretical concepts in a way that enhances the dialogue between ideas and evidence” (Ragin, 2000: 162).

The crossover point (0.5) indicates an ambiguous response, which can neither be said to be in the set nor out of it. This was used to describe P10, who said that there was no ex post opportunism by customers (which could take the form of them leaving the guesthouse without paying their bill), but was one of only two guesthouses to charge in advance. The other, P7, explained that this was done to avoid non-payment. In this case the author has used triangulation between the data collection methods of interviewing and observation, and between participants, to modify the initial scoring of the participant’s verbal response.

There was sufficient theoretically relevant detail in the responses to add two further increments on the scale, enabling a more finely-grained quantitative distinction in the degrees of set membership. A score of 0.75 shows awareness of opportunism as a common occurrence, but with less frequency than was described by participants scoring 1 – making them strong but not full members of the set. In the scores shown in Table 5 below, P7 and P14 scored 0.75 for citing Williamson’s (1975) behavioural examples of false promises made and omission or distortion of information, but excluding deliberate lying which would be unacceptable in the context of village life. The author also used this score to include participants whose descriptions restricted the frequency of opportunism in terms of perpetrators rather than behaviours. P1 and P11 both distinguished between types of people who would or would not be expected to behave opportunistically; in the case of P11, this distinction was drawn along rural/ urban lines. Set membership of 0.25 was given to participants demonstrating an awareness of opportunism in principle, but with limited ability to identify types or perpetrators in practice – making them weak members of the set, but not non-

members. For example, P3 and P6 identified distortion of information as a form of opportunism, but had never experienced lying or false promises. In contrast, P5 and P13 were unable to specify types of opportunist behaviour, but identified market traders as a subset of people who might act opportunistically.

Table 5 Fuzzy set score for interviewees' awareness of opportunism

Case	Score
P1	0.75
P2	0.00
P3	0.25
P4	1.00
P5	0.25
P6	0.25
P7	0.75
P10	0.50
P11	0.75
P12	0.00
P13	0.25
P14	0.75
P16	0.00

A similar procedure was followed for all the remaining 81 sets (see Appendix 1 for a complete list), with the number of values in the scale of set membership determined by the amount of detail and variation in the responses. In all cases, a score of 1 showed perception of high transaction costs or weak institutions that might be associated with the outcome of isolation, and 0 showed low transaction costs or strong institutions that might be associated with integration into the market (or the absence of the outcome of isolation).

In some instances, a four-value scale without a mid-point is appropriate (Ragin, 2005b). For example, in the questions for sets TOL3, 4 and 5, which asked whether an interviewee had experienced opportunism by customers (Buckley and Chapman, 1998a), competitors (Schauwecker and Kühlmann, 2007) or suppliers under small-

numbers conditions (Provan, 1993, Williamson, 1985), there were no ambiguous responses, and so no need for a score of 0.5. A four-value scale was therefore used, with the scores evenly spaced at 0 (never experienced), 0.33 (exceptional, only experienced once), 0.67 (experienced occasionally) and 1 (experienced frequently).

There are also circumstances when uneven spacing of scores is applicable (Rihoux and Ragin, 2009). Question TOL7 asked whether interviewees felt able to judge the likelihood of a person's being an opportunist (Douma and Schreuder, 2008). The responses could populate four values with a mid-point, namely 0 (easy to judge, no transaction cost implication), 0.5 (not relevant, follows denial that there is any opportunism), 0.75 (possible, but transaction costs are incurred in making or acting on the judgment), 1 (impossible, so isolation results). As there were no responses that would fit a weak membership score of 0.25, it was omitted from the scale for this question.

7.1.2 Reduction of fuzzy sets to fsQCA conditions

As stated in the Chapter 5, the data collection exercise was intended to capture a high volume of detailed material, to provide a solid background to the study as well as to provide the raw input to the fuzzy set coding. The 82 fuzzy sets that were coded from the field interview data gave a very rich summary of the interview findings, but required further reduction prior to analysis in fsQCA. It also mentioned that the literature offers guidance as to the number of cases (participating firms) and conditions (scored attributes describing the cases) that fsQCA can manage, and the ratios of cases to conditions that are expected to give reliable solutions.

The number of cases in the study is 13, which conforms with the recommendations for the small-N studies for which the qualitative comparative method is intended: ranging from 2 to 15 (Berg-Schlosser et al., 2009), 4 to 30 (Ragin, 2000), or 5 to 50

(Marx, 2006). The cases are few enough in number that the author has been able to become familiar with each one, and yet they incorporate both positive and negative outcomes (Berg-Schlusser and de Meur, 2009).

The conditions analysed in fsQCA must include one, and only one, outcome condition. This was derived as a higher-order construct from the four sets numbered 23D*, concerning relationships and isolation. These were reduced to a single construct using Ragin's (2000) method of compensation, which takes the mean of the scores for each case to enable a strong performance in one set to make up for weaker performances in others. The author considered this to be the most effective way to climb the ladder of abstraction (Sartori, 1984), as it retains more variation than the alternatives of substitution (which would take each case's highest score from the four sets) or the weakest link (which takes the lowest score). For example, the compensation approach allowed P13's strong performance in customer relationships and personal exchange to make up for a weaker score in horizontal cooperation, and it distinguished between P6 and P14 who share the same maximum and minimum scores. This is very similar to Peng and Luo's (2000) averaging of survey responses concerning strength of participants' ties with customers, suppliers and competitors to create a composite measure for interfirm ties. As a further example of the strength of this approach, cases P2, P12 and P16 all scored 0 for awareness of opportunism in Table 5. But by incorporating P12's high scores for sets TOL9, 11 and 12, this case's overall score for perceived risk of opportunism just crosses the midpoint with 0.52. So the method has been sensitive to the discrepancy in the responses to multiple questions on a related subject – the interviewee said there was no opportunism, but perceived a risk of impersonal exchange from which the only protection was to confine oneself to personal trading.

The most general guidance from the methodological literature is that the total number of conditions (including the outcome and the causal conditions) should be fewer than the number of cases. If there are as many conditions as cases, the problem of uniqueness makes it likely that each case will comprise a unique combination of conditions, and be impossible to generalise from (Marx, 2006); this would limit the fsQCA output to a description of all the cases, rather than a reduced solution. Marx (2006) further discusses a reported possibility that fsQCA could fail to distinguish between real and random data, with the user then in danger of accepting a random and therefore unreliable model. His experiment is based on the idea that fsQCA would have failed to make this distinction if it generated a valid (contradiction-free) model from random data; it would have made the distinction if it did not produce a valid model (i.e. many contradictions remained) from random data. He argues that the ratio of cases to conditions determines this ability to distinguish real from random data, on the basis of uniqueness – if there are so many conditions that the cases are unique combinations, then they cannot be reduced, no contradictions can emerge, and fsQCA is bound to find a contradiction-free model. So the aim is to provide data that offers the scope for reduction and for contradictions, and then to generate a valid model from it. He calculates “safe” proportions of cases to conditions where there is little or no risk of fsQCA generating a model from random data, and so considers these to produce robust models.

A “perspectives approach” was taken to selecting a smaller number of conditions, drawing on theoretical perspectives in the literature to enable the analysis “to adjudicate between competing explanations and to allow for ‘interaction effects’ among certain conditions” (Berg-Schlusser and de Meur, 2009: 26). These perspectives included the recognised causes of transaction costs that might contribute to the outcome, and the institutions that might mediate between the costs and the outcome. The author then used an iterative approach (as recommended by Marx,

2006) to determining the optimum balance between the reduced complexity obtainable by using fewer conditions, and the greater richness of retaining more conditions. This would balance the proportions proposed by Marx (2006) with the presence of contradictions in the truth table.

In the first iteration, the maximum possible of 12 conditions was tested to allow for the most interaction and competition between explanations, whilst still being smaller than the number of cases. The 11 causal conditions were the transaction cost drivers of specificity/ frequency, uncertainty, bounded rationality and opportunism; the formal institutions of finance, government and legal system; and the informal institutions of trust, kinship, *guanxi* and sanctions.

The first of these causal conditions was a higher-order construct, composed of the conditions for specificity and frequency which the author wished to treat as substitutable transaction characteristics, calculated with a Boolean 'OR' (Ragin, 2000). The other conditions were reduced using the compensation method again, which had the advantage of creating a continuous range of scores that were more nuanced than would have resulted from applying 'AND' or 'OR' across the board, which would flatten the results. For example, in the questions that relate to opportunism, P7 and P13 would be scored the same (because both include one or more 0 and 1 scores), where the average scores (see Table 6) put them almost at opposite ends of the scale. At this time, the scores for opportunism were also adjusted upwards by one increment (Ragin, 2000) to reflect the author's concern that the calibration had been affected by the participants' consistent understatement of the issue. Early responses denying opportunism later displayed a tension with the discovery that these individuals traded only with known suppliers – implying that they did in fact perceive the risk of opportunism, but were confident that they had addressed this risk. The adjustment meant that nine participants scored over 0.5 for

opportunism compared to only four before, showing that the five changed scores had been near misses.

Chapter 6 mentioned that there were incomplete data for the questions concerning local government. The compensation approach was modified here to allow for missing values, by calculating the mean for each case based on the number of responses received rather than questions asked.

It was expected that this test of 12 conditions would inflate the problem of limited diversity, which “refers to that situation that not all theoretically possible combinations are represented through empirical cases” (Wagemann and Schneider, 2007: 15). The number of possible combinations is 2^k , where k is the number of conditions; 2^{12} equals 4,096 combinations, and so only a fraction of these could have empirical cases. Furthermore, fsQCA’s resulting truth table and complex solution were composed of unsimplified descriptions of the 13 unique case configurations.

Having established that the 12-condition test was over-complex, in the next iteration the author attempted to over-simplify, thus defining the bounds between which the best solution must sit. The author chose to use only five conditions, because Marx’s (2006) calculations show this ratio of conditions to cases would entail only a minimal risk of an unreliable result from fsQCA. The condition for sanctions was discarded, as it showed insufficient variation in the truth table to contribute to the analysis (Rihoux and Ragin, 2009) and had shown a poor fit with the interview findings. Specificity/ frequency was also discarded, on the basis that this part of the theory was the least-good fit with the context as discussed in Chapter 6. Higher-order constructs were created with the compensation method for formal institutions and for the remaining informal institutions, with the exception of set ITN1 whose minimal variation also suggested a limited applicability of the literature to the cases. A compound set for “transaction costs of incomplete information” was created from the

sets for bounded rationality and uncertainty, linking the risks of information asymmetry and an environment that cannot be fully understood or controlled. This was an experimental compromise to reduce the number of conditions, and not one that the author felt was truly justified by the literature.

This yielded five conditions for the test, the outcome and the four causes of opportunism, incomplete information, informal institutions, and formal institutions. The solution was technically acceptable, having few logical remainders or configurations without cases, and two contradictions. However, the author suspected this to be unnecessarily parsimonious, and so attempted a final test without the compound set for bounded rationality and uncertainty.

The final test, then, used six conditions: the outcome and five causes of opportunism, bounded rationality, uncertainty, informal institutions and formal institutions. According to Marx's (2006) calculations, this would have an acceptably low risk of unreliable results. Furthermore, the resulting truth table included a contradiction, showing that the solution was in fact robust.

This section closes with a presentation of the final scores to be analysed in fsQCA. They are presented in Table 6 below, and the analytical process and findings are discussed in the next section.

Table 6 Fuzzy set data for analysis in fsQCA

Case	oisolated	topportunism	tuncertainty	tboundedrat	iinformal	iformal
P1	0.25	0.58	1.00	0.25	0.39	0.27
P2	0.83	0.39	0.67	0.75	0.82	0.81
P3	0.92	0.75	0.33	0.75	0.90	0.90
P4	0.17	0.57	1.00	0.62	0.26	0.62
P5	0.33	0.36	1.00	0.33	0.21	0.32
P6	0.42	0.54	0.33	0.71	0.62	0.55
P7	0.69	0.87	1.00	0.67	0.69	0.75
P10	0.58	0.60	0.33	0.46	0.58	0.54
P11	0.75	0.79	0.00	0.75	0.64	0.69
P12	0.83	0.52	0.00	0.67	0.88	0.45
P13	0.33	0.32	0.33	0.67	0.44	0.43
P14	0.58	0.65	0.33	0.62	0.53	0.63
P16	0.52	0.23	0.33	0.33	0.68	0.43

7.2 Analysis of the fuzzy set data

The conditions to be examined in the analysis are:

TOPPORTUNISM	high transaction costs of opportunism
TBOUNDEDRAT	high transaction costs of bounded rationality
TUNCERTAINTY	high transaction costs of uncertainty
IINFORMAL	constraint of weak informal institutions
IFORMAL	constraint of weak formal institutions
OISOLATED	outcome of isolation

The standard notation for qualitative comparative analysis is used. Upper case indicates the presence of a condition, and lower case indicates the absence of a condition. The symbols used are:

*	Boolean 'AND'
+	Boolean 'OR'
→	indicates association between condition and outcome

7.2.1 Necessary conditions

As this procedure precedes the truth table analysis, the test for necessary conditions is presented here. However, the results will not be drawn upon until the section presenting the solutions proposed by fsQCA.

7.2.1.1 Conditions necessary for the presence of the outcome

A broad indication of necessity is given by the shape of XY plots, showing each causal condition in turn plotted against the outcome. Figure 8 below shows the causal condition IINFORMAL plotting largely on or below the diagonal, approximating to the lower-triangular plot that would indicate a necessary condition for the outcome. The argument of causal necessity is supported when the outcome is a subset of the cause, that is, where outcome scores are consistently less than or equal to the scores on the cause.

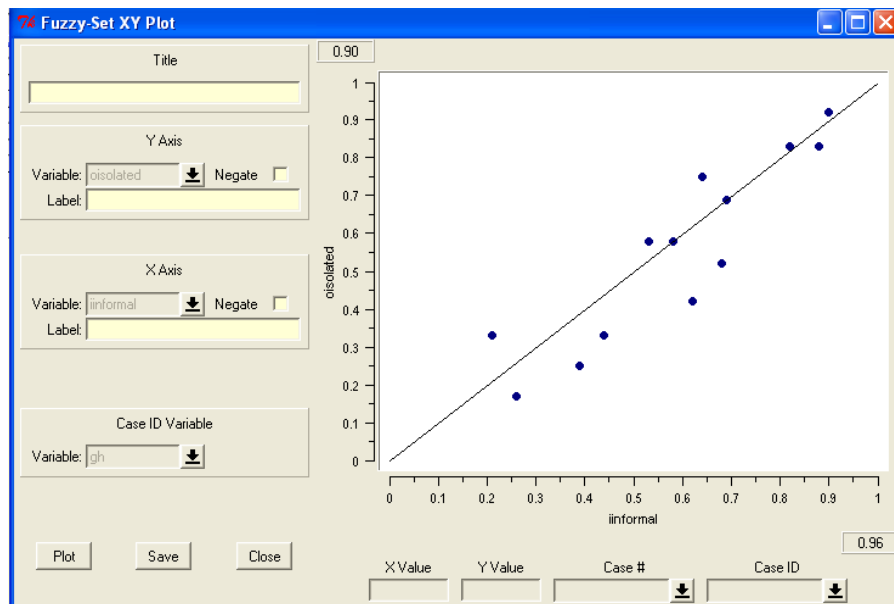


Figure 8 XY plot of IINFORMAL against OISOLATED

The plots for IFORMAL, TOPPORTUNISM and TBOUNDEDRAT both had a less defined shape on both sides of the diagonal, and TUNCERTAINTY was randomly dispersed – suggesting that none of these three conditions on its own is either necessary or sufficient for the outcome.

The fsQCA calculations for necessity offer more detail than the XY plots. Anticipating that empirical data will not fit the subset relation for every case, this measures the degree of fit by adjusting for the number of cases that do not fit, and the distance by which they do not fit (applying less weight to near misses); Ragin (2008b) explains the derivation of the formula used, which is similar to the formula for sufficiency that was presented in Chapter 5. In Table 7 below, condition **IIFORMAL** (marked in bold) has a high consistency score, supporting the argument of necessity, and this is backed up by a fairly high coverage score showing its empirical relevance. The author has defined this “high score” using the procedures recommended for testing the consistency scores for sufficient conditions (see section 7.2.2.1) in the absence of more specific guidance in the literature, using a natural break in the consistency values⁴.

The scores for IFORMAL, TBOUNDEDRAT and TOPPORTUNISM are less definitive, whilst TUNCERTAINTY with its random XY plot behaves differently to all the other conditions: its absence scores more highly than its presence, in a test of necessity for the presence of the outcome. This suggests that the final fsQCA solutions might invert TUNCERTAINTY, but not the other conditions; and therefore

⁴ In contrast, Schneider et al. (2010: 254) set their threshold at 0.9 on the grounds of “conventionality”, even though this resulted in their highest score falling below the threshold by a margin of just 0.01 despite a gap to the next score of 0.08, apparently ignoring the patterns in the actual scores.

that the anticipated link between uncertainty and isolation may be reconsidered because case firms have a broader range of responses to it.

Table 7 Calculation of consistency and coverage for necessary conditions

Conditions tested:	Consistency	Coverage
IIFORMAL	0.956944	0.901832
IFORMAL	0.913889	0.890392
TBOUNDED RAT	0.897222	0.852243
TOPPORTUNISM	0.830556	0.834031
tuncertainty	0.697222	0.789308
topportunism	0.618056	0.763293
iformal	0.590278	0.757576
tboundedrat	0.586111	0.778598
<i>TUNCERTAINTY</i>	<i>0.566667</i>	<i>0.614458</i>
iinformal	0.519444	0.697761

7.2.1.2 Conditions necessary for a non-outcome

The results of the test of necessity for a non-outcome show a similar pattern to the test for the outcome reported above. The absence of IIFORMAL, IIFORMAL, TBOUNDED RAT and TOPPORTUNISM are associated with the absence of the outcome, although the consistency scores are lower (IIFORMAL has the highest consistency score of just 0.87069, coverage 0.942164). TUNCERTAINTY is again with the exception: its presence has a higher score for consistency with a non-outcome (0.768965) than its absence (0.558621).

The results of the tests for necessity do not form part of the truth table procedure, but will be incorporated into the presentation of the fsQCA solutions in section 7.3.

7.2.2 Construction of the truth table

Truth tables are used to evaluate the argument of causal sufficiency, based on the strength of the subset relationship where membership scores in the causal conditions

are consistently less than or equal to the scores on the outcome. fsQCA generates a truth table from the fuzzy set data, with its rows representing causal configurations, and the 1/ 0 values in the cells indicating the individual conditions for which the cases have strong fuzzy set membership scores.

This section presents the two fsQCA truth tables, and explains the decisions made by the author in their construction. For both tables, the frequency benchmark for identifying empirically relevant causal configurations was set to one case with strong membership in the configuration. This is appropriate given the number of cases in this study (Rihoux and Ragin, 2009), and a higher benchmark would fail to include the recommended minimum proportion of 75% of cases (Ragin, 2006) because most rows contained just one case.

7.2.2.1 Truth table for the presence of the outcome

The 13 cases produced a ten-row truth table, with one row including four cases, and leaving 22 configurations as logical remainders. The author set the threshold value for consistency with the argument of sufficiency to 0.97, resulting in six rows being coded as 1 for the outcome OISOLATED. This decision follows best practice in that the chosen value is both substantially higher than the recommended threshold of 0.75-0.85, and is set to coincide with a natural step in the consistency scores (Ragin, 2005b), as shown in Table 8 below:

Table 8 Truth table for presence of the outcome

Case	topportunism	tuncertainty	tboundedrat	iiinformal	iformal	oisolated	consist
P10	1	0	0	1	1	1	1.000000
P12	1	0	1	1	0	1	0.989831
P16	0	0	0	1	0	1	0.981949
P7	1	1	1	1	1	1	0.975343
P2	0	1	1	1	1	1	0.973214
{P3 {P6 {P11 {P14	1	0	1	1	1	1	0.971292
P13	0	0	1	0	0	0	0.912214
P4	1	1	1	0	1	0	0.877676
P1	1	1	0	0	0	0	0.829851
P5	0	1	0	0	0	0	0.800000

This truth table contains one contradiction (Ragin, 1987), suggesting that the data has an appropriate ratio of cases to conditions to enable fsQCA to generate a valid model (Marx, 2006). The multi-case row describes the configuration of conditions for cases P3, P6, P11 and P14, all of which show the outcome except for P6 in which the outcome is absent – meaning that this case is not isolated. There are no rows with fuzzy set contradictions, that is, cases with the outcome but with a low consistency score.

Various options were considered for addressing this contradiction (Rihoux and Ragin, 2009) prior to the analysis of the truth table:

- Adding conditions was rejected, as this would harm the ratio of cases to conditions, and necessitate a return to the field;
- Removing the contradictory case from the analysis was rejected because this would close off a route for exploration of the diversity of cases, in the interests of clean data;

- Examining the outcome scores did not explain the contradiction as a near miss, as P6's score of 0.42 was substantially further from the mid-point than P16 at 0.52, and equidistant with P10 and P14 at 0.58;
- Recoding all cases on the row to 0 was considered unreasonable as two of these cases had a very strong outcome score (P3 = 0.92, P11 = 0.75), and this would also move the threshold value away from the natural break;
- A reexamination of the field notes offered an explanation for the contradiction, but not a solution. All four cases experience similar conditions, and three respond by operating in relative isolation, so a reason was sought as to what made P6 respond differently. P6 and P14 are the best-matched cases for comparison, in terms of their scale of operations. In a detailed comparison between P6 and P14 for the elements contributing to the outcome score, it emerged that both had a similar disinclination to engage in impersonal trade, and both had comparable trading relationships – although P6 had stronger customer relationships due to strong links with international tour operators, while P14 had more diverse supplier relationships which were facilitated by the travel involved in his secondary occupation. The key difference lay in their involvement with horizontal cooperation: P14 does not engage in any form of cooperation, whereas P6 cooperates closely with P4 and loosely with P5. A difference in their trust of remote partners (Zhou and Poppo, 2008) explains their opposite outcome scores, and appears to confirm that P6 is a real negative case – having the relevant causes but not the outcome (Ragin, 2000) – rather than a measurement error.
- The author therefore considered the best option to be a frequency-based coding of the row, where all four cases were coded to 1, in accordance with the outcome displayed by three of the four cases. Amenta et al. (2005) used a frequency basis of more than half of the cases in the row. The validity of the author's decision is

supported by the row having a high consistency score, which would have been lowered if P6 had been a remote outlier. To the contrary, it is a reasonable fit with the configuration of causes scoring less than the outcome.

The decisions regarding the frequency benchmark, the consistency threshold and the contradiction were subsequently reviewed in a series of sensitivity tests, as reported in paragraph 7.2.4. Whilst the discussion above considers case P6 as a truth table contradiction to be addressed, Chapter 8 will explore this case more fully.

7.2.2.2 Truth table for a non-outcome

This again had ten rows, with the four contradictory cases achieving the lowest consistency score out of all the rows: this row would of necessity fall below the consistency cutoff, and so the contradiction had no bearing on the further analysis of the truth table. A natural gap in the consistency scores suggested a cutoff at 0.98 leaving four rows to be coded as 1, being consistent with sufficiency for a non-outcome. This truth table is presented in Table 9 below:

Table 9 Truth table for absence of the outcome

Case	topportunism	tuncertainty	tboundedrat	iinformal	iformal	~oisolated	consist
P5	0	1	0	0	0	1	0.991304
P1	1	1	0	0	0	1	0.991045
P4	1	1	1	0	1	1	0.990826
P13	0	0	1	0	0	1	0.988550
P16	0	0	0	1	0	0	0.895307
P12	1	0	1	1	0	0	0.833898
P2	0	1	1	1	1	0	0.818452
P10	1	0	0	1	1	0	0.813380
P7	1	1	1	1	1	0	0.772603
{P3	1	0	1	1	1	0	0.622010
{P6							
{P11							
{P14							

7.2.3 Analysis of the truth table

The analysis involves a series of minimisations: from the truth table to the complex solution using matched cases, from the complex solution to the intermediate solution using simplifying assumptions that involve easy counterfactuals (Ragin, 2008b), and from the intermediate solution to the parsimonious solution using simplifying assumptions with hard counterfactuals.

7.2.3.1 Analysis for the presence of the outcome

The complex solution has four terms:

- (1) TOPPORTUNISM*tuncertainty* IINFORMAL* TBOUNDEDRAT +
 - (2) TOPPORTUNISM*tuncertainty*IINFORMAL*IFORMAL +
 - (3) TBOUNDEDRAT*TUNCERTAINTY* IINFORMAL*IFORMAL +
 - (4) topportunism*tuncertainty*tboundedrat*IINFORMAL*iformal
- OISOLATED

The first term corresponds to the truth table row for P12 and to the row for P3, P6, P11 and P14. These are matched cases, whose configurations differ only on the condition IFORMAL, which is absent for P12 but present for the other cases. The common outcome of these cases demonstrates that the presence or absence of IFORMAL is not causally important, so can be eliminated to reduce two truth table rows into one solution term.

In a similar manner, condition TBOUNDEDRAT has been eliminated from the row for P10 where it was absent, and from P3, P6, P11 and P14 where it was present, to arrive at the second term. TOPPORTUNISM has been eliminated from P2 where it was absent, and P7 where it was present, to give the third term. The fourth term is an unsimplified reproduction of the row for P16, which could not be matched with any

other cases. We now explain the use of simplifying assumptions and logical remainders in detail, to make this very transparent to the reader (Wagemann and Schneider, 2007).

To reduce the complex solution to a series of intermediate solutions, the following simplifying assumptions were proposed by the author. They were considered to include easy counterfactuals due to their consistency with theoretical knowledge linking their presence with transaction costs (see Chapter 2), with the empirical data's demonstration of their effect in the research context, and with the author's extension of theory from transaction costs to isolation:

1. The presence of TOPPORTUNISM should contribute to the outcome;
2. The presence of TBOUNDEDRAT should contribute to the outcome.

No assumptions were made regarding TUNCERTAINTY due the implication from the majority of positive cases (those displaying the outcome), from the necessity test and from the intermediate solutions tested, that it may be inversely related to the outcome. No assumption was made for a combination of TOPPORTUNISM and TBOUNDEDRAT because such combinations are the subject of this study, rather than the theoretical foundation upon which it is based. Nor were assumptions made for IINFORMAL or IFORMAL, because these are hypothesised by the author to have a moderating effect on the relationship between transaction costs and the outcome, rather than having a theoretically established expectation that they will contribute to the outcome.

Both assumptions were worked through in turn to examine whether the counterfactuals employed by fsQCA would be acceptable to the author. The intermediate solution yielded by the first simplifying assumption – the presence of TOPPORTUNISM – is:

- (1) TOPPORTUNISM*tuncertainty*IINFORMAL+
 (2) TUNCERTAINTY*TBOUNDEDTRAT*IINFORMAL*IFORMAL+
 (3) tuncertainty*tboundedrat*IINFORMAL*iformal
 → OISOLATED

Note that the first term of the intermediate solution contains both the first and the second terms of the complex solution.

The author has aligned the terms of the intermediate and complex solutions in Table 10 below, highlighted (in bold font) which conditions are eliminated from the complex solution, and identified the counterfactual configurations that have been used. This was done to illustrate the derivation of this intermediate solution, and to enable an assessment of the plausibility of the counterfactuals used.

Table 10 Derivation of the intermediate solution where TOPPORTUNISM is assumed to contribute to the outcome

Complex solution	Counterfactual configuration required	Intermediate solution
TOPPORTUNISM* tuncertainty* TBOUNDEDTRAT* IINFORMAL+	TOPPORTUNISM* tuncertainty* tboundedrat* IINFORMAL	TOPPORTUNISM* tuncertainty* IINFORMAL+
TOPPORTUNISM* tuncertainty* IINFORMAL* IFORMAL+	TOPPORTUNISM* tuncertainty* IINFORMAL* iformal	
TUNCERTAINTY* TBOUNDEDTRAT* IINFORMAL* IFORMAL+	N/A	TUNCERTAINTY* TBOUNDEDTRAT* IINFORMAL* IFORMAL+
topportunism* tuncertainty* tboundedrat* IINFORMAL* iformal	TOPPORTUNISM* tuncertainty* tboundedrat* IINFORMAL* iformal	tuncertainty* tboundedrat* IINFORMAL* iformal

The fourth term is a clear example of the use of a counterfactual configuration. In order to eliminate the absence of opportunism from this term, the configuration

‘TOPPORTUNISM*tuncertainty*tboundedrat*IINFORMAL*iformal’ must be used. This configuration is a logical remainder and so can be exercised as a counterfactual to make a matched case, with the assumption that if there were such an empirical case (with TOPPORTUNISM present), it would display the outcome. In this way the configuration leads to the outcome whether opportunism is present or absent, and so it is eliminated from the term in the intermediate solution.

The third term has not been simplified, because TOPPORTUNISM had already been eliminated during the derivation of the complex solution from the truth table.

The first term eliminates TBOUNDEDRAT, using the counterfactual configuration ‘TOPPORTUNISM*tuncertainty*t**boundedrat***IINFORMAL’ – which is in keeping with the simplifying assumption that TOPPORTUNISM is present. The logical remainder exercised is ‘TOPPORTUNISM*tuncertainty*tboundedrat*IINFORMAL*iformal’, which implies an assumption that the presence or absence of IFORMAL can be associated with the outcome, because P10 has the configuration ‘TOPPORTUNISM*tuncertainty*tboundedrat*IINFORMAL***IFORMAL**’.

The author is prepared to accept this assumption, because IFORMAL was demonstrated to have no effect on the outcome during the derivation of the first term of the complex solution from the truth table, and the interview data showed formal institutions to constrain the participating firms less strongly than did informal institutions. Kogut et al. (2004) discuss their own decisions to exclude or retain simplifying assumptions, based on theory and their empirical knowledge.

A similar procedure has been carried out on the second term. IFORMAL is eliminated using the counterfactual configuration ‘TOPPORTUNISM*tuncertainty*IINFORMAL***iformal**’.

It uses the logical remainder ‘TOPPORTUNISM*tuncertainty*tboundedrat*IINFORMAL*iformal’, implying that the presence or absence of TBOUNDEDRAT can be associated with the outcome, because P12 has the configuration ‘TOPPORTUNISM*tuncertainty***TBOUNDEDRAT***IINFORMAL*iformal’.

Again, the author is prepared to accept this assumption, because TBOUNDEDRAT was earlier eliminated to derive the complex solution.

In a test of the second simplifying assumption, that the presence of TBOUNDEDRAT should contribute to the outcome, less reduction is possible. The resulting intermediate solution is:

- (1) *TOPPORTUNISM*tuncertainty*TBOUNDEDRAT*IINFORMAL* +
 - (2) *tuncertainty*TBOUNDEDRAT*IINFORMAL*iformal*+
 - (3) TOPPORTUNISM*tuncertainty*IINFORMAL*IFORMAL+
 - (4) TUNCERTAINTY*TBOUNDEDRAT*IINFORMAL*IFORMAL+
 - (5) topportunism*tuncertainty*IINFORMAL*iformal
- OISOLATED

The first two terms, marked in italics, are prime implicants (PIs). PIs are logically equivalent options for the minimisation of the truth table, and user intervention is required to select the implicant(s) most consistent with theoretical and substantive knowledge (Ragin, 2006). In this case, there are two PIs, relevant to the second and sixth rows of the truth table in Table 8. The user may choose either or both of the PIs, leaving a solution of four or five terms. The relative merits of the PIs are not evaluated here, because they will not appear in the final solution.

The simplifying assumption cannot be used to reduce the third term, because TBOUNDEDRAT was eliminated from this term during the derivation of the complex solution.

The fourth term has TBOUNDEDRAT present, so this cannot be simplified in keeping with the simplifying assumption.

TBOUNDEDRAT has been eliminated from the fifth term, using the counterfactual ‘topportunism*tuncertainty*TBOUNDEDRAT*IINFORMAL*iformal’.

This is the only counterfactual used, and it contains no assumptions about conditions other than TBOUNDEDRAT. As the presence of TBOUNDEDRAT was proposed by the author as an acceptable assumption, there are no further judgments to be made regarding the acceptability of the result.

The limited power of reduction of the second intermediate assumption, and an assessment of the scores for consistency and coverage, resulted in the first intermediate solution being selected as the final solution for a present outcome.

Table 11 below presents the coverage and consistency scores, for each of the solutions under consideration. In terms of solution consistency which is the strength of the subset relation indicating sufficiency, followed by solution coverage which is the empirical importance of this relation (Ragin, 2008b), the first intermediate solution is the strongest, closely followed by the complex and the second intermediate solution, regardless of which PIs were chosen.

This tabulation also shows the first intermediate solution to be strongest at the level of individual terms, because the terms have been simplified. For example, where the first and second terms of the complex solution have been amalgamated to form the first term of the first intermediate solution, the consistency of the argument becomes

stronger, and both the raw and unique coverage scores are higher because the term includes more cases.

The second intermediate solution is further considered to be weaker than the first, because four of its five terms have a consistency score lower than the lowest term-level consistency score in the first solution (0.97254). In conclusion, the first intermediate solution is chosen because it has stronger explanatory power, and its simplifying assumptions are justified in the literature.

Table 11 Coverage and consistency scores for presence of outcome

Solution type	Solution coverage	Solution consistency	Solution term	Raw coverage	Unique coverage	Consistency
Complex	0.851389	0.959311	TOPPORTUNISM*tuncertainty*TBOUNDEDRAT*IINFORMAL+	0.573611	0.009722	0.971765
			TOPPORTUNISM*tuncertainty*IINFORMAL*IFORMAL+	0.575000	0.011111	0.971831
			TUNCERTAINTY*TBOUNDEDRAT*IINFORMAL*IFORMAL+	0.547222	0.225000	0.977668
			topportunism*tuncertainty*tboundedrat*IINFORMAL*iformal	0.377778	0.026389	0.981949
1 st intermediate: TOPPORTUNISM present	0.856944	0.959565	TOPPORTUNISM*tuncertainty*IINFORMAL+	0.590278	0.179167	0.972540
			tuncertainty*tboundedrat*IINFORMAL*iformal+	0.394444	0.026389	0.982699
			TUNCERTAINTY*TBOUNDEDRAT*IINFORMAL*IFORMAL	0.547222	0.225000	0.977668
2 nd intermediate: TBOUNDEDRAT present	With both PIs: 0.855556; With 1 st PI: 0.855556; With 2 nd PI: 0.851389	0.943338	topportunism*tuncertainty*IINFORMAL*iformal+	0.416667	0.026389	0.940439
			0.943338	TOPPORTUNISM*tuncertainty*IINFORMAL*IFORMAL+	0.575000	0.011111
	0.943077	TUNCERTAINTY*TBOUNDEDRAT*IINFORMAL*IFORMAL+	0.547222	0.225000	0.977668	
		tuncertainty*TBOUNDEDRAT*IINFORMAL*iformal+	0.425000	0.004167	0.956250	
		TOPPORTUNISM*tuncertainty*TBOUNDEDRAT*IINFORMAL	0.573611	0.000000	0.971765	

The parsimonious solution, in which fsQCA exercises any necessary assumptions and hard counterfactuals without any intervention by the user, is:

IINFORMAL
→ OISOLATED

– meaning that a high score for informal institutions would be considered to be sufficient for the outcome.

This simplification from the first intermediate solution uses hard counterfactuals and assumptions that the author rejects. These assumptions are presented as two rounds of eliminations in Table 12 below:

Table 12 Derivation of the parsimonious solution for the presence of the outcome

Cases	First intermediate solution	Result of 1 st round of eliminations	Result of 2 nd round of eliminations	Parsimonious solution
P3, P6, P10, P11, P12, P14	TOPPORTUNISM* tuncertainty* IINFORMAL+	tuncertainty* IINFORMAL+		IINFORMAL
P2, P7	TUNCERTAINTY* TBOUNDEDRAT* IINFORMAL* IFORMAL+	TUNCERTAINTY* TBOUNDEDRAT* IINFORMAL+	TUNCERTAINTY* IINFORMAL	
P16	tuncertainty* tboundedrat* IINFORMAL* iformal	tuncertainty* tboundedrat* IINFORMAL	tuncertainty* IINFORMAL	

In the first round of eliminations, TOPPORTUNISM is eliminated from the first term by using the simplifying assumption that if opportunism were absent, the outcome would be unchanged. This contradicts the author's simplifying assumption of

opportunism being present, which was an easy counterfactual, and so cannot be accepted.

The second and third terms require the elimination of both the presence and the absence of IFORMAL, but without the support of matched cases. This effectively assumes that formal institutions have no impact on the outcome regardless of the other conditions, but this is not evident in the literature and so would constitute a hard counterfactual: this is also rejected. Note the distinction between this and the acceptable elimination, which was performed during the derivation of the complex solution that was based on matched cases.

The second round of eliminations assumes both the presence and absence of TBOUNDEDRAT from the second and third terms, which again are not matched. The presence of TBOUNDEDRAT was considered as an easy counterfactual in the derivation of the intermediate solution, and so this assumption of its absence cannot be accepted.

The final stage reduces two matched terms, ‘tuncertainty*IIFORMAL’ and ‘TUNCERTAINTY*IIFORMAL’. In this case the presence and absence of uncertainty, in combination with IIFORMAL, is associated with the outcome, and so uncertainty can safely be eliminated.

Because the parsimonious solution requires three sets of assumptions that the author does not accept, the intermediate solution is selected in preference to the parsimonious solution. Furthermore, the parsimonious solution has a much lower consistency score (0.901832) than all the other solutions, making it a less powerful solution despite having higher coverage (0.956944). The reader should note that this is a rejection of the parsimonious solution on methodological grounds, but that the

importance of informal institutions (as a necessary condition and in the intermediate solution) is a key finding of this study.

7.2.3.2 Analysis for a non-outcome

The complex solution consists of three terms:

- (1) TUNCERTAINTY*tboundedrat*iinformal*iformal+
 - (2) topportunism*tuncertainty*TBOUNDEDRAT*iinformal*iformal+
 - (3) TOPPORTUNISM*TUNCERTAINTY*TBOUNDEDRAT*iinformal*
IFORMAL
- isolated

The first term is a reduction of the truth table rows for cases P1 and P5, which are matched for all conditions except TOPPORTUNISM, which can therefore be eliminated. The second and third terms are the complete truth table records for cases P13 and P4 respectively, which could not be matched with other cases.

A series of simplifying assumptions were tested for the non-outcome. These were informed both by theoretical knowledge, and by the substantive knowledge gained from the tests for the presence of the outcome. They comprised the absence of TOPPORTUNISM, TBOUNDEDRAT and IIFORMAL, and the presence of TUNCERTAINTY, contributing to a non-outcome. However, the intermediate solutions were rejected for three reasons:

1. Whilst assumptions could reasonably be made regarding the relationship between transaction cost drivers and the outcome based on the literature, this is less easy to justify for the non-outcome. The literature does not anticipate the outcome of an absence of transaction cost drivers.

2. The non-outcome describes a much broader range of behaviours (including specialisation or integration in response to low transaction costs, and internalisation or cooperation with high transaction costs) than the outcome of isolation, so it is harder to make assumptions about individual causes of these types of behaviour.
3. Very little simplification was achieved by the assumptions tested: none was able to reduce the number of terms, and only a very few conditions were removed from individual terms.

In sum, the assumptions could not be strongly justified, and there would further have been very little gain in terms of minimisation. As a numeric illustration, see the assessment of scores in Table 13 below: the first intermediate solution with TOPPORTUNISM absent has slightly higher scores for solution coverage and consistency than all the other solutions, but lower term-level scores than the second and third intermediate solutions. This is not considered to be sufficiently strong statistical support to overturn the author's rejection of the simplifying assumptions, and so the complex solution is the preferred solution.

Table 13 Coverage and consistency scores for absence of outcome

Solution type	Solution coverage	Solution consistency	Solution term	Raw coverage	Unique coverage	Consistency
Complex; intermediate: INFORMAL absent	3 rd 0.818965	0.993724	TUNCERTAINTY*tboundedrat*iiinformal*iformal+	0.648276	0.122414	0.992084
			topportunism*tuncertainty*TBOUNDEDRAT*iiinformal*iformal+ TOPPORTUNISM*TUNCERTAINTY*TBOUNDEDRAT*iiinformal*IFORMAL	0.446552 0.558621	0.120690 0.043103	0.988550 0.990826
1 st intermediate: TOPPORTUNISM absent	0.827586	0.993789	TUNCERTAINTY*tboundedrat*iiinformal*iformal+	0.648276	0.122414	0.992084
			TUNCERTAINTY*TBOUNDEDRAT*iiinformal*IFORMAL+ topportunism*tuncertainty*TBOUNDEDRAT*iiinformal*iformal	0.584483 0.446552	0.051724 0.120690	0.991228 0.988550
2 nd intermediate: TBOUNDED absent	0.818965	0.993724	TOPPORTUNISM*TUNCERTAINTY*iiinformal+	0.622414	0.043103	0.991758
			TUNCERTAINTY*tboundedrat*iiinformal*iformal+ topportunism*tuncertainty*TBOUNDEDRAT*iiinformal*iformal	0.648276 0.446552	0.058621 0.120690	0.992084 0.988550
4 th intermediate: TUNCERTAINTY present	0.818965	0.993724	topportunism*iiinformal*iformal+	0.717241	0.120690	0.992840
			TUNCERTAINTY*tboundedrat*iiinformal*iformal+ TOPPORTUNISM*TUNCERTAINTY*TBOUNDEDRAT*iiinformal*IFORMAL	0.648276 0.558621	0.037931 0.043103	0.992084 0.990826

The parsimonious solution was:

iiinformal
→ oisolated

This is the inverse of the solution for the presence of the outcome, and is derived by means of simplifying assumptions that are rejected for the same reasons. The author rejects the parsimonious solution for the non-outcome because it relies on assuming the presence and absence of IFORMAL, TBOUNDEDRAT and TOPPORTUNISM for non-matched cases. Furthermore, the parsimonious solution has a much lower consistency score (0.942164) than all the other solutions, making it a less powerful solution despite having higher coverage (0.87069).

7.2.4 Sensitivity testing

The decisions made during data analysis have been presented, and justifications offered, in the preceding sections of this chapter. In the following section, they will be subjected to sensitivity tests with the intention of further demonstrating their validity. These tests do not address simplifying assumptions: although the findings are sensitive to the assumptions adopted, they were tested during the iterations of the main analysis, and only justifiable assumptions were accepted.

7.2.4.1 Frequency benchmark in the truth tables

In both of the truth tables there were ten rows containing cases, nine rows with one case each, and one row with four cases. In order to set a more stringent benchmark than the frequency of one case that was used in the main body of the analysis, it would be necessary to raise the threshold so that only the single row of four cases was included.

In the table for the presence of the outcome, this would leave one row representing one causal configuration, and only 31% (4/13) of the cases. Although it would be feasible to analyse this table, the empirical support it would offer to the conclusions would be unacceptably weak. The recommended minimum coverage of cases is 75% (Ragin, 2006), and the main analysis was far stronger with 100%.

If this test were applied to the truth table for the absence of the outcome, the same 31% of cases would be included. However, because they occupy the contradictory row with three of the four cases having the outcome, the analysis for a non-outcome could not proceed.

7.2.4.2 Contradictory configuration in the truth tables

The most practical alternative for addressing the contradiction that was not pursued in the main analysis, was to recode all of the cases on the contradictory row to 0. Rihoux and Ragin (2009) cite Nomiya's (2001, material in Japanese) testing of a truth table, with contradictory rows coded first as 1, and then again as 0. When the current author performed this test in a separate iteration of the present analysis, by raising the consistency cutoff from 0.971 to 0.973 to exclude this row, the result was weaker:

- The cutoff point had moved from a natural break in the consistency scores, to an arbitrary point between two values. Only five rows with five configurations and 38% (5/13) of the cases remain to be analysed, instead of six rows representing 69% (9/13).
- The resulting solutions could not be minimised as effectively as in the main analysis. The complex solution contained four rows – the same number as in the

main analysis, but with more conditions. Its consistency was slightly higher at 0.968978, but the coverage was markedly lower at 0.7375.

- The minimisation of the parsimonious solution was unsatisfactory, still containing three terms after the selection of one out of two PIs. Here again, consistency was a little stronger than in the main analysis at 0.911565, but with much lower coverage of 0.744444.
- The substance of the parsimonious solution was also inconclusive, with TOPPORTUNISM being eliminated altogether, and TUNCERTAINTY being both present and absent (or just present, depending on the PI chosen).

The author has interpreted these weaker solutions as supporting the original decision to code the contradictory row to 1 in the truth table where the outcome is present.

In the truth table for a non-outcome, the contradictory row was originally coded as 0, and so was already excluded from the sufficiency analysis and had no impact on the results. There were no instances of fuzzy set contradictions, and so no need to apply sensitivity tests to their resolution.

7.2.4.3 Threshold value for consistency

The aim here will be to test whether changing the consistency threshold from that used in the main analysis can effectively simplify the resulting solutions or increase the scores for consistency or coverage.

The truth table for a positive outcome originally had six rows coded to 1. The preceding paragraph concerning contradictory rows has already explored the effect of raising the threshold value, and found the results to be less strong than the original analysis. The remaining test, therefore, is to lower the threshold.

By lowering the threshold from 0.97 to 0.91, case P13 can also be included. Although this has the advantage of now including 77% (10/13) of the cases, this comes at the cost of ignoring the natural step in the consistency values, and of including a contradiction. P13, and all cases further down the truth table, do not display the outcome in their fuzzy set scores; when their outcome is coded as 1 in the truth table despite their low consistency scores, they become fuzzy set contradictions. The recommended action for this type of contradiction is to recode the outcome to zero (Rihoux and Ragin, 2009), which would effectively cancel this test, so it will be run with the aim of simply showing it to be weaker than the original analysis.

The parsimonious solution has two terms compared to the original single-term solution, due to the need for a PI to include case P13, and has a dangerously low consistency score of 0.816918 – a score of 0.75 could not support any argument of sufficiency (Ragin, 2008b). The complex solution is one term longer than the original, with a substantially lower consistency score of 0.925982 and an unchanged coverage score. The consistency scores have been lowered by the inclusion of P13 in a test of conditions sufficient for an outcome that it does not display, and this is also reflected in the term-level score.

The non-outcome truth table originally had four cases coded to 1. By increasing the threshold from 0.98 to 0.99, P13 is excluded. The three remaining cases naturally give a much reduced complex coverage score of only 0.698276, offering only very weak empirical support to the causal argument despite the consistency being unchanged.

If instead the threshold is lowered to include P16 as the fifth case, the same problem arises of creating contradictions. This requires a PI to derive a two-term parsimonious solution with a low consistency score of 0.881188; the complex solution has a weaker consistency score than the original at 0.944762.

All of the results of this test are taken to confirm that the consistency thresholds were set at appropriate levels in the main analysis.

7.2.4.4 Tests for necessary conditions

Although the solutions generated by the sufficiency tests are not sensitive to the necessity tests that preceded them, they do support the conclusions that were drawn regarding necessity. The respective presence and absence of the condition IINFORMAL was found to be necessary for the presence and the absence of the outcome, and this is borne out by its appearance in all of the terms of the chosen solutions.

In contrast, IFORMAL had a more marginal result for necessity. It appears as both present and absent within each solution, showing that the decision not to consider it to be necessary was correct. TUNCERTAINTY is also shown not to be necessary, but its inversion in the majority of the solution terms supports the suggestion that it behaves differently to the other conditions.

7.3 Findings from the data analysis

The final solutions reached as a result of the fsQCA analysis are restated below.

7.3.1 Solution for the presence of the outcome

The first intermediate solution was selected:

TOPPORTUNISM*tuncertainty*IINFORMAL+
 tuncertainty*tboundedrat*IINFORMAL*iformal+
 TUNCERTAINTY*TBOUNDEDRAT*IINFORMAL*IFORMAL+
 → OISOLATED

The cases represented by the first term of this solution are P3, P6, P10, P11, P12 and P14; this includes the negative case P6, which shares the causal configuration but not the outcome. The second term represents only case P16, and the third term represents cases P2 and P7. The remaining cases are covered by the solution for a non-outcome.

The presentation may be simplified without changing the substance of the solution, by separating out the conditions that are common to all terms as follows:

```
IINFORMAL*
((TOPPORTUNISM*tuncertainty)+
(tuncertainty*tboundedrat*iformal)+
(TUNCERTAINTY*TBOUNDEDRAT*IFORMAL))
→ OISOLATED
```

This simplified presentation highlights the presence of the necessary condition IINFORMAL in every term of the solution, but also shows that this condition alone is not sufficient for the outcome. This means that all of the cases that are isolated are also constrained by weak informal institutions, in combination with high or low transaction costs and weak or strong formal institutions.

The solution's causal statement is plotted against the outcome in Figure 9 below. Quadrant 1 contains the cases that display the outcome and the causal configuration contained in the solution, whilst Quadrant 2 contains cases with neither the outcome nor the cause. Quadrant 3 highlights the exception to this pattern, P6, which will be examined further in Chapter 8, as will the plot as a whole.

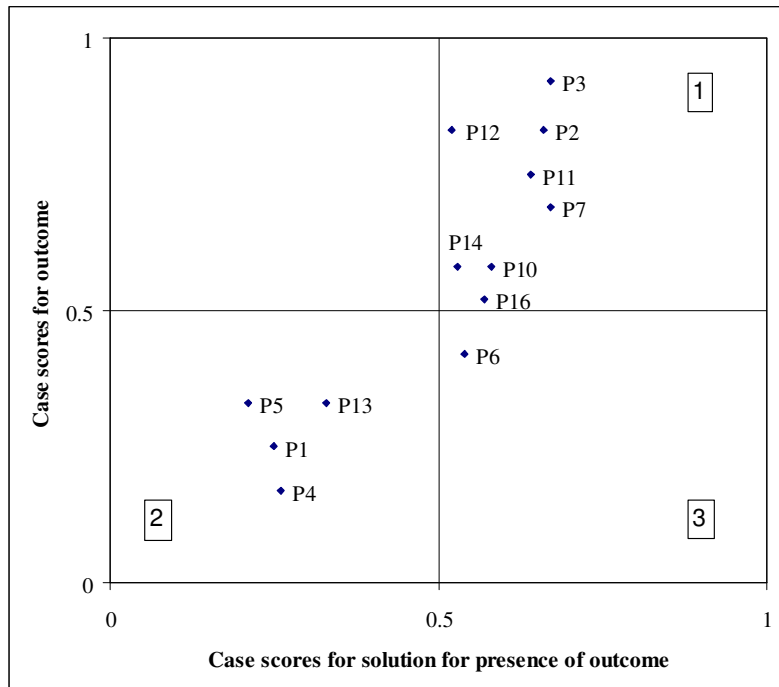


Figure 9 Plot of fsQCA scores for the presence of the outcome

(Source: author)

The solution has scope for logical simplification, by eliminating elements that are logically redundant (Ragin, 2000). As the third and fourth terms contain the same combination of conditions but with opposite signs, they effectively cancel each other out. If IINFORMAL in combination with *either the presence or the absence* of ‘TUNCERTAINTY*TBOUNDEDRAT*IFORMAL’ leads to the outcome, then the latter combination has no effect on the outcome, which can be caused by IINFORMAL alone. The solution could therefore be reduced to:

IINFORMAL+
 IINFORMAL*(TOPPORTUNISM*tuncertainty)
 → OISOLATED

Now the containment rule can be applied to achieve further logical simplification. The cases described by the second term are also described by the first term: the first term contains the second term, making the second term redundant. The simplest possible solution would therefore be:

IINFORMAL
 → OISOLATED

This elimination of logically redundant terms has produced the same solution as fsQCA's parsimonious solution, which was rejected by the author because of the hard counterfactuals it incorporated. The same counterfactuals are implicitly drawn upon to transform IINFORMAL from a condition that was originally shown to be necessary but not sufficient for the outcome, into a condition that is both necessary and sufficient in its own right. This solution is therefore unacceptable, as well as placing excessive emphasis on parsimony above complexity (Ragin, 2008b), giving a less complete account of the cases with the outcome. Because this solution has eliminated some terms to increase its parsimony, it has at the same time lost some of the richness or complexity that will drive the subsequent discussion. The author therefore chooses not to proceed with this logical simplification, but instead to retain the simplified presentation of the solution for further discussion.

7.3.2 Solution for the absence of the outcome

The complex solution was selected:

TUNCERTAINTY*tboundedrat*iiinformal*iformal+
 topportunism*tuncertainty*TBOUNDED RAT*iiinformal*iformal+
 TOPPORTUNISM*TUNCERTAINTY*TBOUNDED RAT*iiinformal*IFORMAL
 → oisolated

The cases represented by the first term of this solution are P1 and P5, the second term is P13, and the third term is P4.

This may also be presented in a simplified form, as:

$$\begin{aligned} & \text{iinformal*} \\ & ((\text{TUNCERTAINTY*tboundedrat*iformal})+ \\ & (\text{topportunism*tuncertainty*TBOUNDEDRAT*iformal})+ \\ & (\text{TOPPORTUNISM*TUNCERTAINTY*TBOUNDEDRAT*IFORMAL})) \\ & \rightarrow \text{isolated} \end{aligned}$$

Once again, this shows that absence of condition IINFORMAL is necessary but not sufficient for the non-outcome. The cases that are not isolated do not feel constrained by weak informal institutions, but this always occurs in combination with high or low transaction costs and strong or weak formal institutions. No logical simplification of this solution is possible.

This solution is plotted against the non-outcome in Figure 10 below. This follows the same pattern as the plot for the outcome, grouping together the cases without the outcome in Quadrant 1, the cases with the outcome in Quadrant 2, and the negative case in Quadrant 3. This plot will be discussed further in Chapter 8.

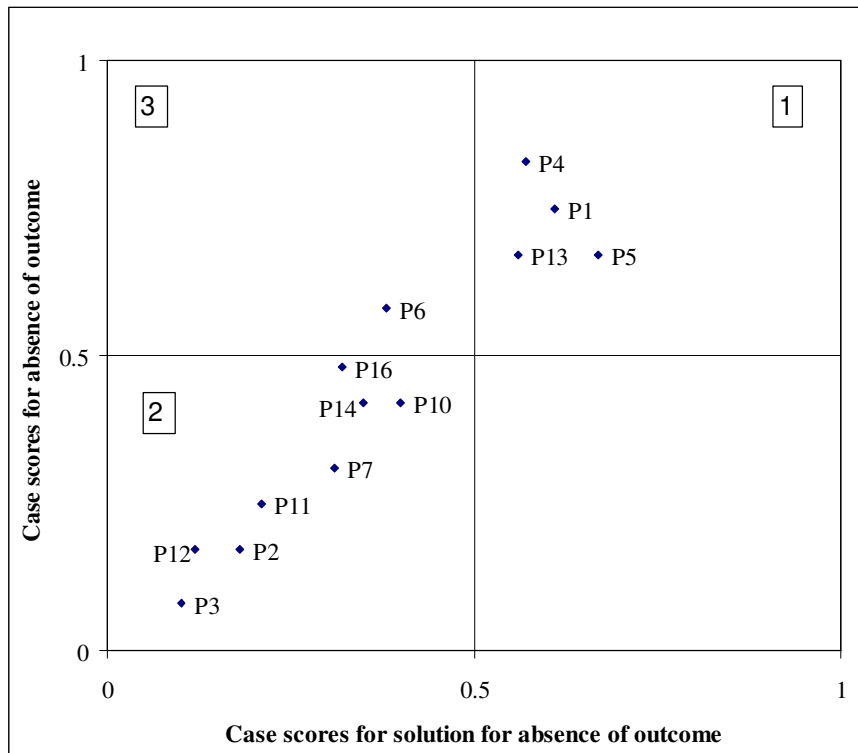


Figure 10 Plot of fsQCA scores for the absence of the outcome

(Source: author)

Two different solutions have been derived for the presence and the absence of the outcome, demonstrating causal asymmetry in that one is not simply the inverse of the other. The terms they contain are different, as some are conducive to the outcome whilst others impede it, but they produce consistent results: the scores calculated for each case plot somewhere in the same quadrant regardless of the solution used.

Juxtaposition of the solutions

The solutions for the outcome and the non-outcome can more easily be compared when presented together:

IINFORMAL*
 ((TOPPORTUNISM*tuncertainty)+
 (tuncertainty*tboundedrat*iformal)+
 (TUNCERTAINTY*TBOUNDEDRAT*IFORMAL))
 → OISOLATED

iinformal*
 ((TUNCERTAINTY*tboundedrat*iformal)+
 (topportunism*tuncertainty*TBOUNDEDRAT*iformal)+
 (TOPPORTUNISM*TUNCERTAINTY*TBOUNDEDRAT*IFORMAL))
 → oisolated

As a broad generalisation, cases are isolated when they experience both high transaction costs and weak informal institutions, the exception being P16 (in the third term of the solution, or third row of the truth table in Table 8) who experiences weak informal institutions and isolation in spite of low transaction costs. Cases are generally not isolated when their high transaction costs are accompanied by strong informal institutions. This is illustrated at case-level in the truth table in Table 8, where the fourth row (case P7) and the eighth row (P4) differ only on informal institutions and outcome. These observations will be discussed more fully in the next chapter.

CHAPTER 8 DISCUSSION

Chapter 6 discussed the findings for each interview theme in the light of the literature, addressing the two gaps that had been identified (namely isolation as a response to transaction costs, and the empirical study of informal institutions in the Chinese context) and answering the first two research questions (opportunism, bounded rationality and uncertainty as the principal causes of transaction costs perceived by the participants, and a common response of isolation). It also offered a preliminary answer to the third research question: that weak formal institutions prevented the predicted responses of contracts, internalisation and cooperation, and the nature of informal institutions also constrained cooperation, so firms avoided transactions to reduce behavioural transaction costs. The chapter concluded with the proposition that high transaction costs and weak institutions were associated with the outcome of isolation.

Chapter 7 described the reduction of the interview data and how they were analysed in fsQCA, finishing with the solution statements for the presence and absence of the outcome of isolation. This chapter now discusses these findings with reference to the literature, the participating firms and an ideal type configuration to answer the third research question: Can an understanding of local institutions help us to understand the firms' response to transaction costs, if it differs to that expected by theory? In the light of the findings reported so far, we can reshape the question: Why is it that some of the participants respond to transaction costs by structuring their businesses in an economically sub-optimal way? They could perform better, and contribute more to local economic development, if they responded by cooperating, leading to wider and then impersonal trading, enabling them to specialise. Which features of the institutional context intervene between the perception of transaction costs and the response to it, and how do they operate to constrain firms' choice of responses?

8.1 Discussion of the truth table data

We first discuss what can be learnt from the preliminary analysis of the truth tables, before addressing the solution statements. The aim here is to review the behaviour of causal factors, and to seek insights from patterns across cases (Daniels and Cannice, 2004). Extracts of the truth tables, which were presented in full in Chapter 7, are given in Table 14 and Table 16 below for the reader's convenience; Table 15 illustrates the ideal type configuration, where high transaction costs and weak institutions are associated with the outcome of isolation.

Table 14 Truth table extract for rows associated with presence of the outcome

Case	topportunism	tuncertainty	tboundedrat	iinformal	iformal	oisolated
P10	1	0	0	1	1	1
P12	1	0	1	1	0	1
P16	0	0	0	1	0	1
P7	1	1	1	1	1	1
P2	0	1	1	1	1	1
{P3	1	0	1	1	1	1
{P6						
{P11						
{P14						

Table 15 Ideal type configuration for the presence of the outcome

Case	topportunism	tuncertainty	tboundedrat	iinformal	iformal	oisolated
Ideal type	1	1	1	1	1	1

Table 16 Truth table extract for rows associated with absence of the outcome

Case	topportunism	tuncertainty	tboundedrat	iinformal	iformal	~oisolated
P5	0	1	0	0	0	1
P1	1	1	0	0	0	1
P4	1	1	1	0	1	1
P13	0	0	1	0	0	1

Reading down the columns of these tables, it is clear that condition IINFORMAL (weakness of informal institutions) always scores 1 when the outcome OISOLATED is 1, and 0 when the outcome is 0. This characteristic is not shared by any of the other conditions, all of which may score 1 or 0 for cases with either outcome. This means that all nine cases that share strong membership of the set of isolated firms (Table 14) also share strong membership of the set of firms perceiving weak informal institutions (scoring 1), and the four cases that are not isolated (Table 16) share the common feature of strong informal institutions (scoring 0). This relationship between IINFORMAL and the outcome illustrates the key finding of the tests for necessary conditions reported in Chapter 7. These tests yielded a high score (0.96) to support the argument that weak informal institutions were a necessary condition for isolation, and that strong informal institutions were necessary to avoid isolation. The high scores in the tests proposing this relationship are confirmed by the positive relationship between IINFORMAL and OISOLATED in the case-level data: all of the isolated cases had weak informal institutions, and all non-isolated cases had strong informal institutions.

The other interesting finding of the test for necessity was the behaviour of condition TUNCERTAINTY, representing high transaction costs related to an uncertain environment, which was also the only condition to show random dispersal in the XY plot against isolation. The conditions IFORMAL (weak formal institutions), TBOUNDEDRAT (transaction costs of bounded rationality) and TOPPORTUNISM (transaction costs of opportunism) all scored between 0.83 and 0.91 for consistency with the argument of necessity, and seven out of the nine cases with the outcome in Table 14 score 1 for each of these conditions; the remaining two cases show that the consistency scores give weaker support to this argument than they do for IINFORMAL. In contrast, the absence of uncertainty scored more highly (0.70) in the test of necessity for isolation, than its presence (0.57), although both scores were

lower than those for the other conditions. In the truth tables, the behaviour of TUNCERTAINTY is less consistent, where its impact on the outcome is considered in combination with other factors. Its absence is associated with the outcome more often than its presence, where seven of the nine isolated cases score 0 for uncertainty, and its presence is associated with the non-outcome in three out of four cases. Although Chapter 6 found that participants' response to the individual factor of uncertainty was not the avoidance of trading, it appears that this response may be less consistent when considered together with other factors.

8.1.1 Comparison to an ideal type configuration

Reading along the rows, the cases can readily be compared to the ideal type configuration. P7 conforms exactly to the ideal type, being a strong member of all the sets for high transaction costs, weak institutions and the outcome of isolation.

The next best fit to the ideal type with strong membership of four out of the five causal conditions are the group of P3-P6-P11-P14 (which includes the negative case P6, marked in italics in Table 14) who also reported weakness in both types of institutions, and perceived two out of three types of transaction costs (opportunism and bounded rationality), and similarly P2 (with uncertainty and bounded rationality, but not opportunism). A moderate fit with the ideal type, agreeing on three out of the five conditions, is shown by P12 who perceived the same types of transaction costs as the group of P3-P6-P11-P14, but differed in reporting strong formal institutions, and P10 who perceived weakness in both types of institutions but only opportunism as a cause of transaction costs, not uncertainty or bounded rationality. P16 shows a very poor fit with the ideal type, agreeing only on the necessary condition of weak informal institutions, and perceiving low transaction costs and strong formal institutions. The sharpest contrast between isolated firms is between P16, which does

not match the ideal type, and P7, which matches exactly: the only causal factor they have in common is weak informal institutions.

An ideal type has been proposed for the outcome of isolation but not for the absence of the outcome, because (as explained in Chapter 5) causal symmetry is not assumed. However, it may be noted that amongst the cases without the outcome, P4 in fact makes a very good fit with the ideal type as it has strong membership of all conditions except for strong informal institutions – making this case the exact opposite configuration to P16. P5 and P13 are near opposites of the ideal type, reporting strong institutions and having strong membership only of uncertainty and of bounded rationality respectively, whereas P1 has both opportunism and uncertainty. P13 had reported confidence in legal protection against opportunism and in impersonal trading, contributing to his avoidance of the outcome of isolation.

The truth table row for the group of P3-P6-P11-P14 demonstrates clustering of cases on the causal configuration with transaction costs of opportunism and bounded rationality, weak informal and formal institutions, and isolation. The number of cases, and the high scores for consistency (above the threshold value) and raw coverage reported in Chapter 7, show this configuration to be empirically important. Its proximity to the ideal type thus lends it support, particularly as the cluster differs from the ideal type only on the transaction cost of uncertainty, which was found to behave differently from the other transaction costs in the test for necessity.

The cluster illustrates a pattern of causal factors that often coincide, and in three out of four cases the pattern is associated with the outcome of isolation. The consistency score for all four cases was reported earlier as 0.97; if we recalculate this to exclude the negative case P6, the score for the group P3-P11-P14 rises to 1.00, giving the strongest possible support for the argument of sufficiency for the outcome of isolation. As the consistency score including P6 was above the threshold value for

sufficiency, it can be seen that the inclusion of P6 has not materially weakened the argument of sufficiency, so the configuration remains important.

8.1.2 Exploring key differences

Following the exploratory study, the author had considered isolation to be a possible response to high transaction costs. However, the analysis of the truth tables has shown that high transaction costs alone do not explain the outcome of isolation. P7 and P4 both perceived all three types of transaction costs, but P7 was isolated and P4 was not. The only difference in causal factors between P7 and P4, who both perceived high transaction costs and weak formal institutions but had different outcomes, is that P4 reports strong informal institutions in contrast to weakness reported by P7.

Furthermore, if isolation were a response to high transaction costs, and if the causation were perfectly symmetrical, we might expect low transaction costs always to be associated with the absence of the outcome. However, P16 is isolated despite perceiving low transaction costs, demonstrating at least an exception to causal symmetry. It appears that his report of weak informal institutions may help to explain the unexpected outcome of isolation.

The apparent interaction between transaction costs and institutions supports the author's inclusion of both high transaction costs and weak institutions as casual factors in the ideal type. Whilst Chapter 4 suggested that institutions might be a factor influencing the response to transaction costs, and that formal and informal institutions have different effects on the level of transaction costs and on firm's responses, there was no suggestion at that stage that one might affect the response more strongly than the other. However, it now appears that a contingent factor

between the presence or absence of the outcome may be the strength or weakness of informal institutions.

There could also be further causal factors that contribute to the outcome but have not been included in the analysis. One suggestion made in the literature regards the constraint imposed by firms' stability or stage in development on their responses to transaction costs. Martinez and Dacin (1999) suggest that firms that are doubtful of their survival, or are in decline, may prioritise immediate concerns over long-run efficiency and so make decisions that appear not to be in their long-run interests. This could help to explain the coincidence of high transaction costs and a response of isolation in P2 and P3 (where survival is in doubt) and P7, P11 and P12 (who are in current or imminent decline). However, there are also stable firms that respond to transaction costs with isolation (P10, P14 and P16), so this factor does not offer a consistent explanation and is not considered to contribute substantially to the findings.

8.1.3 Responses to combined causal factors

Here we use the truth tables to explore firms' responses to combinations of causal factors that were discussed in Chapter 2.

Williamson (1985) expects that bounded rationality in an uncertain environment will limit firms' otherwise possible responses to information asymmetry, and result in the increased likelihood of internalisation. This combination is evident in the truth tables, but appears not to have a consistent effect on the response of isolation that is under current examination. P2 and P7 have the combination and are isolated, whereas P4 has the combination and is not isolated. P10 and P16 do not perceive either cause, and yet they are both isolated. Both outcomes are also observed for participants perceiving the combined factors of opportunism and bounded rationality

(Williamson, 1985), where P3-P6-P11-P14 and P7 are isolated, but P4 is not; opportunism and uncertainty (Artz and Brush, 2000), as P7 is isolated, but P1 and P4 are not; and opportunism, uncertainty and weak formal institutions (Zhou and Poppo, 2008), where P7 is isolated, and P4 is not.

More support is offered for the connection between transaction costs and informal institutions, than for simple combinations of transaction costs. In the case of informal constraints to reduce opportunism (North, 1990), seven of the nine participants reporting weak informal institutions also perceived high transaction costs of opportunism, suggesting that the weakness of informal institutions was not helping to reduce their perception of opportunism. In contrast, only half of the four participants with strong informal institutions perceived opportunism. Regarding the proposal that trust might moderate the effect of uncertainty (Madhok, 1995), this also appears to be supported: three (P1, P4 and P5) of the four participants reporting strong informal institutions (and thus integration rather than isolation) also perceived uncertainty.

There is not an evident pattern of transaction cost drivers that prompted P1, P4 and P16 to specialise, but did not prompt the other participants to do so. All three had very different perceptions of transaction costs: P16 perceived none at all, supporting the expectation that low transaction costs enable specialisation (Arora et al., 1996), and no other participants had such low transaction costs. However, P4 had high costs in all three categories, and P1 had two out of three, yet both participants have specialised regardless. P7 has the same high costs as P4, but has not specialised. It may be that P16's low transaction costs have enabled him to specialise despite his isolation (whose composition reflects a constraint of personal exchange rather than limited numbers of suppliers), whilst P1 and P4 have been able to specialise because of their integration into the market – and in spite of their high transaction costs.

The complexity of these alternative causal paths that can be taken to reach the same outcome is better explored through a continued discussion of the fsQCA analysis than simply with reference to the truth tables.

8.2 Discussion of the fsQCA solution statements

Chapter 7 explained how the solution statements for this study were derived and offered arguments to support the decisions and assumptions that were made during this process. The purpose of this section is to illustrate the good fit of these decisions made with the case observations and the literature, in addition to examining the correspondence of the solutions to the ideal type, and answering the third research question. The solutions prompt us to ask questions about contrasting cases, offering insights into causal processes that may be at work; these are then explored further with the aim of deepening our understanding of the participants' responses. The solutions for both the presence and the absence of the outcome are discussed in turn, in search of further insights and to further explore the extent to which causal symmetry may be present.

8.2.1 Solution for presence of the outcome

Chapter 7 presented the derivation in fsQCA of the solution statement for the presence of the outcome:

$$\begin{aligned} & \text{IINFORMAL*} \\ & ((\text{TOPPORTUNISM*}t\text{uncertainty})+ \\ & (t\text{uncertainty}*t\text{boundedrat}*i\text{formal})+ \\ & (\text{TUNCERTAINTY}*T\text{BOUNDEDRAT}*I\text{FORMAL})) \\ & \rightarrow \text{OISOLATED} \end{aligned}$$

This solution demonstrates multiple conjunctural causality (Berg-Schlosser et al., 2009): it comprises three terms joined by ‘OR’ statements, showing multiple causality, and each of these terms is comprised of many conditions acting in combination joined by ‘AND’ statements, showing conjunctural causality.

Each of the three terms must be accompanied by IINFORMAL, as indicated by the ‘AND’ statement in the first line. This identifies IINFORMAL as a necessary condition as all solution terms contain it, and also shows that on its own it is not a sufficient condition, as it is always combined with other conditions in a solution term. This means that weak informal institutions are present for every case whose response is isolation, but informal institutions alone cannot account for isolation. This is consistent with the findings of Peng and Luo (2000), in whose study informal ties between firms in China were found to be necessary to firm performance but not sufficient in the absence of firms’ other value-adding activities. It also supports the author’s decision to combine transaction costs with institutional theory, as both are present in every term of the solution. All three terms of the solution represent causal paths that are associated with a single outcome of isolation, demonstrating equifinality.

The interview data had suggested that opportunism was a key contributor to the outcome of isolation, and the truth tables showed uncertainty to behave in an inconsistent manner as it was associated with both the presence and the absence of isolation. Both of these patterns are reflected in the solution for isolation, where opportunism is always present (due also to its inclusion in the simplifying assumption) and uncertainty may be present or absent. Bounded rationality and formal institutions can also be either present or absent, as the interview data indicated that both of these conditions were a hindrance to trading for some but not all cases.

8.2.1.1 Illustrating the steps in the derivation with reference to cases and theory

The first term of this solution represents a cluster of six cases (P3, P6, P10, P11, P12 and P14). The cases P3, P6, P11 and P14 shared a common configuration in the truth table, and were matched with P12 as they had opportunism, bounded rationality, weak informal institutions and the absence of uncertainty in common. In this configuration, it made no difference to the outcome whether formal institutions were weak or strong, which suggests that factors other than the strength of formal institutions were important in shaping these firms' response. Whilst Zhou and Poppo (2008) considered weak legal institutions to cause firms to prefer relational to contractual governance, here the weakness of formal institutions appears to be less important than other factors.

P10 was matched in a similar manner, having the conditions of opportunism, weak formal institutions, weak informal institutions and the absence of uncertainty in common with P3, P6, P11 and P14. Here the presence or absence of bounded rationality had no effect on the outcome, perhaps being outweighed by the lack of protection from opportunism by either formal (North, 1994a) or informal (Poppo and Zenger, 2002, Peng, 2004) means.

P2 and P7 were merged into the third term, sharing uncertainty, bounded rationality, and weak formal and informal institutions. Williamson (1985) expects uncertainty and bounded rationality together to greatly increase the risk of transactions. This risk, combined again with a lack of formal or informal protection, may have been so high that the further presence or absence of the additional risk of opportunism made no difference to the response.

Further reduction of the solution resulted from the simplifying assumption that the presence of opportunism should contribute to the outcome, by virtue of increasing

transaction costs (Williamson, 1975) to which firms might respond by isolation (as discussed in Chapter 3). This had the effect of consolidating the configuration for P3, P6, P11, P14 and P12 with that for P3, P6, P11, P14 and P10 to complete the first term of the solution, by matching counterfactual configurations with P12 and P10. These again eliminated bounded rationality and formal institutions, allowing all six cases to be grouped together under their common conditions of opportunism, weak informal institutions and the absence of uncertainty. The anticipated need for informal protection from opportunism (Poppo and Zenger, 2002, Peng, 2004) is thus reflected in the final solution, where opportunism accompanied by weak protection by informal institutions is associated with isolation.

The simplifying assumption also applied to P16, whose configuration in the truth table included the absence of opportunism. As the assumption had been made that the presence of opportunism would be associated with the outcome, this eliminated opportunism from the solution term that covers only P16, and which comprises the absence of uncertainty and bounded rationality, weak informal institutions and strong formal institutions. This case does not fit the author's expectation of isolation as a response to high transaction costs, and so will be discussed further.

8.2.1.2 Correspondence to ideal type

The solution term that corresponds most closely to the ideal type configuration, sharing four of its five conditions, is the third term. It may be considered to be the most important of the terms as it has the highest scores for consistency and for unique coverage (Schneider et al., 2010), meaning that it alone is sufficient cause for the most cases – with others being explained by more than one term where they overlap. This importance, combined with the good fit to the ideal type, supports the argument that high transaction costs and weak institutions may be the cause of isolation. However, the first term scores more highly for raw coverage, as it covers a

much higher proportion of the cases, although part of this coverage overlaps with other terms and so is not unique. As the first term has empirical importance, the condition on which it diverges from ideal type (namely the absence of uncertainty) is also important – but the advantage of reduced uncertainty is outweighed by the presence of opportunism and weak informal institutions, and isolation results all the same.

The second term (covering P16) indicates that the ideal type configuration is not the only route to the outcome of isolation. It disagrees on three of the four conditions, sharing only the necessary condition. So even where isolated cases share the necessary condition and the outcome, sufficiency cannot be achieved simply by adding the high transaction costs and weak institutions of the ideal type. Even if firms are in the strong position of perceiving low transaction costs and strong formal institutions, as P16 does, they may still be hindered from integration in to the market – and the only remaining causal factor to explain this is informal institutions. This suggests that informal institutions may play an even more important role than we had previously thought. This raises a question of whether weak informal institutions on their own comprise a sufficient handicap to integration, such that they can cause a firm to be isolated even in the absence of high transaction costs. Of the other eight isolated cases, half have lower fuzzy set scores than P16 for weak informal institutions and half have higher scores, so P16's median score seems unlikely to be a sufficient cause in accounting for his unexpected isolation. We conclude, for the time being, that P16 constitutes an exceptional case: it combines the necessary condition of weak informal institutions with the advantages of low transaction costs and strong formal institutions, and has an outcome of isolation.

8.2.1.3 XY plot of solutions for the outcome

The plot of the cases' fuzzy set scores for the solution statement against their scores for the outcome was shown in section 7.3.1 of Chapter 7. These scores were calculated from the detailed fuzzy set data that were imported into fsQCA, upon which the simplified presentation of the truth table was also based. The quadrants marked on the plot indicate the mid-point on the scale from 0 to 1 that divides strong from weak fuzzy set membership. Quadrant 1 groups together the eight cases that display the outcome and the causal configuration contained in the solution, whilst the negative case P6 plots in quadrant 3 because it is present in the causal statement but not in the outcome. Quadrant 2 contains the four cases with neither the outcome nor the cause, which will be discussed in section 8.2.2. The clustering of most cases into quadrants 1 and 2 indicates that the relationship that the author has proposed between high transaction costs, weak institutions and a response of isolation, is largely supported by the empirical data – excepting the negative case and P16's exception.

Whilst the grouping of most cases into quadrants 1 and 2 supports the proposed relationship, their distribution within the quadrants also illustrates the deliberate oversimplification of the ideal type that would plot in the upper right-hand corner. The quadrant 1 cases show variation on both axes, illustrating their relative positions in the multi-dimensional vector-space: P3 has the highest score for the solution statement and the outcome of isolation, whereas by contrast P10 has a lower causal score and a much lower outcome score. This is a graphical illustration of the two cases' rows on the truth table, where P3 had strong membership in four of the five causal conditions, whereas P10 had strong membership in only three.

P2 and P12 have exactly the same score for the outcome, generated from very different causes (they have opposite views on opportunism, uncertainty and formal institutions) that have resulted in their being covered by different terms of the

solution statement. Equifinality can thus even apply to uniformity in the degree of the outcome, not just the causal paths leading to it. In contrast, P3 and P7 have the same causal score and coverage by different solution terms, but for P7 this is associated with a lower score for the outcome.

8.2.1.4 P6 as a negative case

Although we have explained above that P6's inclusion in the first solution term has not materially reduced this term's importance, understanding what causes P6 to behave as an exception to the general pattern is an important question meriting further investigation (Öz, 2006). Why, when this firm has all five causal factors in common with three other cases in the truth table, four factors in common with the ideal type, and is covered by the same solution term as five other cases, does it not share their outcome of isolation? The answer may lie in the situational context in which P6 is embedded, a feature of which has not been accounted for in the causal conditions analysed.

Chapter 7 confirmed that P6's outcome score was not marginal, and compared its composition to that of P14, identifying P6's greater inclination for horizontal cooperation as the key to her lower outcome score (indicating integration rather than isolation). A further difference in the composition (but not the values) of the scores was their compensatory scores in trading relationships. Whilst neither case was isolated from customers or suppliers, with all scores being less than 0.5, P6 was more strongly integrated in customer relationships, whilst P14 was more integrated with suppliers.

Knowledge of P6's situation helps to explain these differences. Chapter 6 explained the significance of relationships with international tour operators, and observed that P14's hosting of tour groups was declining whilst P6 was doing well, particularly in

maintaining a good working relationship with TO2. P6 was the only participant to mention the importance of good customer service during the data collection interviews, which the author considers to be a factor in her popularity with international operators who (or whose clients) value this. The relative locations of the participating firms are an important consideration in understanding their inclination to cooperate. P14 gave no reason for his reluctance to cooperate, but his very close proximity to two other guesthouses and easy road access to three more has resulted in an environment of fierce competition in which outdoing other firms may come more naturally than seeking areas of mutual benefit. In contrast, P6 has a prime location on the main tourist path, far enough from neighbouring guesthouses not to be in direct competition with them. This explains her willingness to cooperate loosely with her neighbour at P5, and closely with P4 who is more distant still. P6 capitalises even further on her customer and cooperative relationships, by integrating her relationships with P4 and TO2 rather than keeping them separate. TO2 is a regular client of both P4 and P6, but P4's location is reached first on TO2's standard itinerary. P6 has chosen to receive TO2's booking information via P4, meaning that TO2's administrative tasks are effectively halved (potentially increasing goodwill towards P6), and P6 benefits from both P4's and her own good relations with TO2.

This sheds light on P6's response: although she perceives opportunism and bounded rationality, and her report of weak formal and informal institutions explains her reluctance to engage in impersonal exchange, she is still open to trading with known suppliers and manages her relationships with customers and peers exceptionally well. Whilst this increases our understanding of what caused the contradiction, it has not resolved it and so the solution cannot be said to be sufficient for all cases. Ragin (1987) suggests that further causes can be added in order to tune the solution more finely until it offers a complete explanation for the outcome. The author considers the solution to have identified the main pattern explaining participants' behaviour,

and considers the identification and consequent deeper examination of this exceptional case to have added to the value of this study – much as Ragin (2000) himself intended in his emphasis on seeking diversity rather than homogeneity. For this reason, the contradiction has been retained at present, and more detailed study of it may drive part of the author's future research agenda.

8.2.1.5 Summary

The solution has offered broad support for the argument that the ideal type configuration of high transaction costs and weak institutions leads to the outcome of isolation, although an exception is made for the condition of uncertainty that has been found to have inconsistent effects. In contrast to Williamson's (1985) expectation, participants in this study did not respond to uncertainty by avoiding transactions, although it could be associated with isolation when combined with other conditions. The solution further confirms that weak informal institutions are a necessary but not sufficient cause for the outcome of isolation.

8.2.2 Solution for the absence of the outcome

Whereas a single truth table can display the configurations that are associated with both the presence and the absence of the outcome, scores for consistency and coverage need to be calculated separately in support of arguments for the outcome and for the non-outcome, and separate solution statements derived for the outcome and for the non-outcome. The current study is focussed specifically on an outcome of isolation as opposed to more traditionally expected outcomes, and so does not particularly seek reasons why isolation should not come about. However, exploring the non-outcome may offer new insights into the causal patterns. In particular, our observation of a potential intervention by informal institutions between transaction

costs and responses would be more strongly supported if a similar effect were observed for the non-outcome.

The solution for a non-outcome presented in Chapter 7 was the complex solution generated by fsQCA, meaning that there are no simplifying assumptions that require illustration here. Furthermore, there were no contradictions or negative cases in the non-outcome.

iiinformal*
 ((TUNCERTAINTY*tboundedrat*iformal)+
 (topportunism*tuncertainty*TBOUNDEDRAT*iformal)+
 (TOPPORTUNISM*TUNCERTAINTY*TBOUNDEDRAT*IFORMAL))
 → oisolated

This solution again shows multiple conjunctural causation, being composed of three terms of four or five conditions each. The cases covered by the first term of this solution are P1 and P5 (a matched pair eliminating TOPPORTUNISM), the second term is P13, and the third term is P4. Very little simplification has been achieved in this solution, with a single cluster generalising between two cases, and the second and third terms each describing a case in full. All terms share the necessary condition of strong informal institutions, and perceive at least one cause of transaction costs. An early suggestion would be that all of these firms perceive at least a low level of transaction costs, yet none is isolated; the only condition they all have in common is strong informal institutions, which may intervene in avoiding isolation as a response to the transaction costs.

All of the non-isolated cases had low scores for trust, as they suffered less constraint than other firms in who to trust, and they used their networks to positive effect. This enabled P4 to trade widely and cooperate to overcome high transaction costs as

recommended by Rao (2003) and others, resulting in her integration rather than isolation despite these perceived costs. In the first term, very high uncertainty has not prevented specialisation by P1, perhaps reflecting the benefits of Hu's (2007) *guanxi* community in contrast to other authors' fears of constraints. P13 does not specialise or cooperate, and yet is integrated into a network of customers and suppliers, whose development was presumably supported by the ease with which this participant developed personal and impersonal trust (Humphrey and Schmitz, 1998).

8.2.2.1 Ideal type

The author has not proposed an ideal type configuration for the absence of the outcome, as the theoretical background supports proposing conditions that might lead to isolation, and only inverting this (and thus assuming causal symmetry) would offer an ideal type for non-outcome with any theoretical support. That being said, we earlier identified the second term of the solution for the outcome as the term that disagreed with the ideal type for the outcome on three of its four conditions. Similarly, the first and second terms of the solution for the non-outcome agree on only one condition each – so three of the four cases without the outcome disagree with the ideal type for the outcome. Taken together with the high consistency and coverage scores for the first term, it therefore appears that there may be a degree of symmetry in the empirical data after all. The exception to this is the third term of the solution for the non-outcome, which agrees with the ideal type for all conditions except informal institutions, and yet does not have an outcome of isolation. As with P16, informal institutions are the only factor agreeing to ideal type, further suggesting their great importance.

8.2.2.2 Comparison between solutions for the presence and absence of the outcome

In the solution for the absence of the outcome, all of the causal conditions (except the necessary condition of strong informal institutions) can be either present or absent. This does not, however, demonstrate a lack of causal symmetry so much as the author's decision to apply a simplifying assumption only to the solution for the outcome, which forced opportunism always to be present. There is, in fact, a degree of symmetry within the outcomes, as well as between them. Within the solution for the outcome, the second and third terms are symmetrical in all of their sufficient conditions; this is also apparent in the second and third terms for the non-outcome, although only for three of the four sufficient conditions. Near-symmetry between solutions can be seen between the third term for the outcome and the first term for the non-outcome, and between the second term for the outcome and the third term for the non-outcome – although both of these are exceptions to the general pattern. Again this requires us to look more closely at P4: with high transaction costs we expect her to be isolated, but her strong informal institutions apparently intervene. The cases to which she is most similar (P2 and P7) have the opposite outcome, and of the cases to which she is most different (P5, P13 and P16), P16 is exceptional in itself, and the remaining two share her outcome but with very different configurations. This will be explored further below.

The symmetry between the third term for the outcome and the first term for the non-outcome is only disrupted by the failure of TUNCERTAINTY to change its sign. This could be taken as further support for our observation of its inconsistent behaviour, or else might indicate that high uncertainty can be counteracted by strong formal institutions (observed only for P1 and P5) to avoid isolation.

The low level of transaction costs in the first and second terms for the non-outcome does not explain by itself the covered cases' ability to avoid isolation. If it did, the first and second terms of the solution for the outcome might also have avoided isolation.

Opportunism has been shown to be a particularly prevalent cause of high transaction costs in the research context, and the author has earlier combined the literature and the interview data to support an expectation (expressed as a simplifying assumption) that opportunism would only ever be associated with the outcome of isolation. However, the third term of the solution for the non-outcome includes opportunism, so it does not always lead to isolation. This term has all three types of transaction costs and weak formal institutions, in marked similarity to the third term of the solution for the outcome – suggesting once again that the strength or weakness of the informal institutions accompanying transaction costs can change the response to high transaction costs.

8.2.2.3 Exploring P4's response

We adopt the approach suggested by Berg-Schlusser and de Meur (2009) to pairing up cases for closer examination, to help identify decisive conditions and explore how their interplay affects the presence or absence of the outcome, both in similar cases (most similar causes with different outcomes, or MSDO) and in contrasting cases (most different causes with similar outcomes, or MDSO). To identify the pairs, we refer to the truth table to review Boolean distance. For MSDO this enables us to select P7 in preference to P2, as it has more causal factors in common with P4. Similarly, P13 exhibits the most causal differences to P4 for the MDSO comparison.

In the MSDO comparison, P7 and P4 had strong membership of all the causal conditions in the truth table, except for P4's non-membership for weak informal

institutions. They had the same fuzzy set scores for uncertainty (both having grave concerns about the dam, and identifying uncertain demand due to the 2008 Olympics), and very close scores (with a difference of only 0.05) for bounded rationality (with P7 perceiving marginally more risk in asymmetry and language). They both perceived weakness in formal institutions, with P7 reporting more distrust of officials, vulnerability to their unfairness and exposure to impersonal trade in the absence of legal protection – with their scores differing by 0.13. A larger difference of 0.20 on their perception of opportunism was due to P7's more frequent experience of opportunism by suppliers and his fear of the risk this posed to his firm. The only condition that triggered different memberships in the truth table, with a range of 0.43, was informal institutions. P7 was much less inclined to trust others, limiting this to family and long-standing acquaintances, not extending it to new contacts or organisations as P4 did, or using small-volume trades to develop trust; he was also more constrained to trading and employment within his social network, and lacked any political connections. The difference of 0.36 in the outcome scores, which resulted in P7's isolation and P4's integration, is traced to P7's much smaller number of suppliers, all of whom he knew personally and trusted (in contrast to P4's impersonal trading), and also his declining involvement with tour operators and cessation of cross-referring with other guesthouses. P4's ability to develop new trust relationships is thus considered to be key to her different outcome, and confirms the importance of informal institutions in overcoming high transaction costs.

We contrast this with the MDSO comparison. P4 and P13 again had very similar scores for bounded rationality and demonstrated similar strengths in informal institutions, with P13 having a similar approach to the development of trust and occasionally trading outside the network. P13 had more confidence (by 0.19) in formal institutions – citing the beneficial effects of local government, reduced tax bills, and reliance on legal protection – and less fear of opportunism (by 0.25,

occurring less regularly and not preventing impersonal trade), yet they still both avoided the outcome of isolation. The large difference (0.77) in uncertainty was due to P13's lack of concern for the uncertain environment, which did not prevent either firm from trading. So although P4 and P13 display causal differences, their similarity in trust is key to their shared outcome of avoiding isolation.

8.2.2.4 XY plot of solutions for the non-outcome

The plot for the non-outcome was shown in section 7.3.2 of Chapter 7. It can be seen that P5 and P13 had the same fairly low score for isolation, although P5 reported stronger informal institutions than P13. This demonstrates transaction costs and institutions working in combination to achieve the outcome, because if strong institutions alone explained the outcome, P13 would be more isolated than P5. P13's equal degree of integration is apparently made possible by his lower transaction costs, which help to avoid isolation despite the relatively weaker informal connections.

This plot is consistent with the plot for the outcome, in that the same grouping of cases into quadrants occurs whichever solution is used to calculate the scores plotted. Thus, the interesting observations yielded by the solution for the non-outcome have enriched our understanding of the relationship between causal conditions and responses, without changing the proposals we have made concerning this relationship. We therefore refer only to the solution for the outcome in our further discussion, which proceeds with a consideration of interaction between the conditions.

8.2.3 Discovery of an interaction effect

The expectation formed during the discussion of the interview findings, and presented as an ideal type, was that high transaction costs and weak institutions would be associated with the outcome of isolation. However, the fsQCA analysis has shown that this is not always the case, and has indicated a further, underlying causal mechanism. A condition is said to have a contingent effect if it can be associated with the presence and the absence of the outcome, depending on which other conditions it is combined with. We see this interaction in the conditions of high transaction costs, which are generally associated with an outcome of isolation, but may instead lead to integration if they are also combined with strong informal institutions.

This was observed in the truth tables where P7 and P4 both perceived high transaction costs and weak formal institutions, but P7 reported weak informal institutions and was isolated, whilst P4 reported strong informal institutions and avoided isolation. This also contrasts with P16's low transaction costs combining with weak informal institutions to result in isolation. The contingent causal factor triggering their different responses to the level of transaction costs is the strength or weakness of informal institutions. It is further noted that P16, whose low transaction costs originally led us to expect him not to be isolated, were also accompanied by strong formal institutions. The implication of this is that the contingent effect of weak informal institutions can not only result in isolation despite low transaction costs, but can also result in isolation despite strong formal institutions.

The mechanism by which this interaction effect works was uncovered in the exercise of contrasting P4 with P7 and P13. Where P4 and P7 had similar perceptions of transaction costs, P4's readiness to establish new trust relationships enabled her to avoid P7's isolation. P4 perceived higher transaction costs than P13, but shared

P13's outcome of integration as a result of both participants' willingness to trust. It is here that our abductive reasoning has inferred the operation of an underlying causal process that was not immediately apparent in the empirical data collected: that informal institutions, and specifically the ability to develop new trust relationships, is critical to the avoidance of isolation.

The new insight offered by this inference is that in the presence of high transaction costs, the strength or weakness of informal institutions is the critical factor determining whether or not firms are able to avoid isolation. Whereas the empirical observation of firms' behaviour had led us to think that institutions had a moderating effect on the relationship between transaction costs and isolation, our analysis has enabled us to identify the specific effect of an individual institutional factor. We now present our full answer to the third research question.

8.3 Research question 3

The third research question asked whether an understanding of local institutions could help to explain firms' responses to transaction costs. Chapter 6 concluded with a preliminary answer, that weakness of formal institutions prevented the literature's expected responses of contracts, internalisation and cooperation, and the nature of informal institutions also hindered cooperation, so firms reduced behavioural transaction costs by avoiding transactions and became isolated as a result.

It made the proposition that high transaction costs and weak institutions were associated with isolation, which was examined further in the discussion of the fsQCA solutions in this chapter.

Institutions had first been considered as a factor in shaping firms' responses to transaction costs, when the exploratory study (reported in Chapter 3) suggested that they were constraining participants' ability to cooperate with each other and with

tour operators, and increasing their reluctance to trade. The influences included an atmosphere of fear preventing open discussion of opposition to the dam, a shortage of funding and costs of pollution contributing to competitive pressures, regulations limiting foreign ownership and employment practices, purchasing decisions shaped by pre-existing trust relationships, and the importance of kinship and social or *guanxi* networks. These factors were subsequently expressed as formal and informal institutional constraints on the participants' responses to transaction costs.

The interview findings supported this approach of drawing on transaction cost and institutional theories, by showing that transaction costs were high and that institutions both affected the level of transaction costs and restricted firms' range of options in responding to them. The broad outline of the fsQCA results confirmed that high transaction costs were generally associated with a response of isolation, and detailed examination of the results indicated more complex patterns of causality – combining transaction cost and institutional conditions – than had been apparent from the thematic analysis of the interview data.

The dominant feature of the multiple and conjunctural paths to the outcome of isolation was the identification of informal institutions as a necessary condition. This highlighted that, where our attention in this study was focussed on trading isolation as an outcome, the informal features of the environmental context were more formative of firms' actions than the formal features, which have dominated other writers' discussions of contracting and internalisation as responses. It further demonstrated that transaction costs on their own were not a sufficient condition leading to isolation: every causal path was composed of the necessary condition of informal institutions, supported by a mix of transaction cost and formal institutional conditions, which combined to make sufficient terms.

A further layer of complexity was added by the contingent nature of causality, in which the interaction between transaction costs and the strength or weakness of informal institutions affected the outcome. The solution terms identified cases where high transaction costs could be associated with outcomes of either isolation or integration, depending on whether they were combined respectively with weak or strong informal institutions. There were also terms illustrating cases whose lower transaction costs could result in the expected integration when accompanied by strong informal institutions, or unexpectedly still lead to isolation if informal institutions were weak.

The implications of this are suggested by Peng and Luo's (2000) proposed connection between firms' competitive performance and their dependence on informal connections: whilst all firms can benefit from inter-firm ties, less competitive firms may rely on them more heavily than more competitive firms. If firms begin from an uncompetitive position and so rely on their informal connections to drive performance, but these connections are weak, this will hinder their performance (reflected in our outcome of isolation), and fail to contribute to their competitive position. Firms with strong informal institutions, in contrast, can draw on these to improve their competitive position and degree of integration, becoming less dependent on these institutions over time. This illustrates the absolute necessity of informal institutions in this research context: they are a first step on the road to integration, without which firms will not become more competitive or move from isolation to integration. This carries ominous implications for the participant firms reporting weak institutions, in particular the less competitive among them, who may be more constrained by this weakness than the firms who are already in a more competitive position, and so be left behind. This emphasis on the necessity of informal institutions, however, did not mean that they alone were sufficient for the outcome. As the analysis has shown, the degree of integration associated with strong

informal institutions was still moderated by the accompanying level of transaction costs.

Our short answer to the third research question is that local institutions do affect firms' responses to transaction costs, and that informal institutions are a necessary but not sufficient condition in deciding between the responses of isolation and integration. This is illustrated in Figure 11 below, where the causal paths diverge as strong informal institutions allow a response to transaction costs of relational trading, and weak institutions prevent this and so lead to isolation. Elaborating upon this adds to the second observed gap in the literature, concerning the empirical study of informal institutions in China with regard to their constraint on firms' responses to transaction costs. Chapter 6 found trust to be a scarce resource in the research site, which was of benefit to firms who were party to trust relationships but was not readily extended to other firms. The observation of the current chapter, that trust was the mechanism by which the contingent effect of informal institutions operated, makes it all the more important that trust should circulate more widely to address the present constraints. Some participants' readiness to enter into new trust relationships enabled them to overcome the high transaction costs that more reticent participants could not, resulting in their integration despite these transaction costs. Willingness to trust could also level the playing field, enabling participants perceiving high or low transaction costs to avoid isolation.

By way of further explanation for Figure 11, it is the third of a sequence of four flowcharts. Whereas Flowchart 1 illustrated the theory of causes of and responses to transaction costs, and Flowchart 2 added intervening institutional factors and a response of isolation (drawing on the exploratory study and the institutional literature), this third chart makes further changes to reflect the findings of our analysis. Less-important causal factors (specificity, frequency and uncertainty) have

been bracketed out, as have the less important institutions (formal and sanctions). This focuses our attention on the causal path running from behavioural causes of transaction costs, to the deciding factor of informal institutions, and on to an outcome of either isolation or integration.

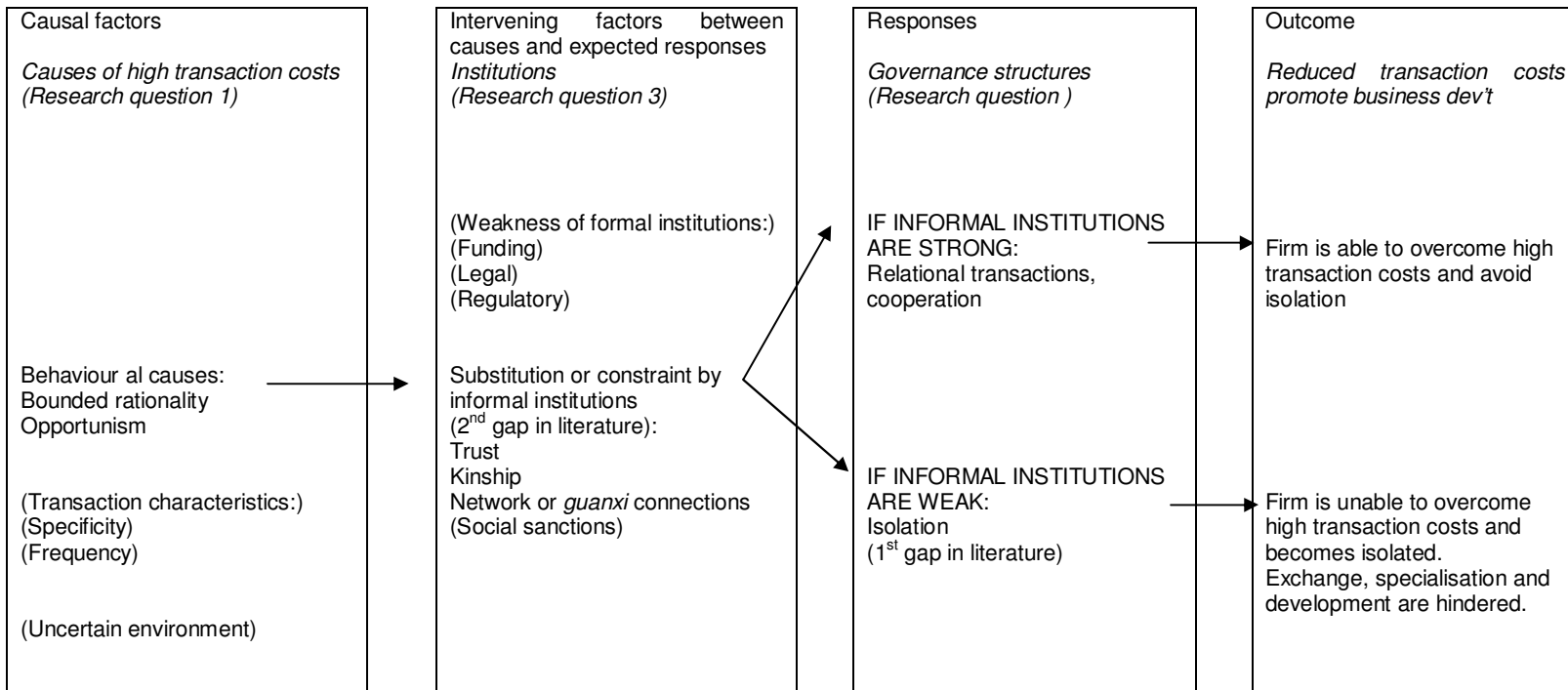


Figure 11 Flowchart 3 – Model of the contingent effect of the strength or weakness of informal institutions on the outcome

(Source: author)

8.4 Conclusion

Granovetter (1985) anticipated an uneven distribution of trust relationships, explaining that this is why opportunism and distrust persist even when transactions are embedded in social relations of trust. This embeddedness describes a compromise position of personal exchange, when neither generalised morality (in which trust is predicated on the assumed absence of opportunism) nor formal institutional protection can be relied upon. However, in this study's research site, the situation is less well-developed even than this compromise, as the order-sustaining structure of networks of relationships that Granovetter envisages is in fact more a series of dyadic trust relationships, in which missing relationships or gaps in the network result in isolation. Granovetter's (ibid.) conceptualisation of a spectrum from generalised morality (which does not exist in the field site, as the development of trust is specific and very constrained), through personal exchange embedded in social networks (which is the closest approximation to the field site) to reliance on institutional protection (very limited in the field site), suggests that the situation could be improved by increases in the generalisability of trust, or in the reliability of formal institutions, or both.

We can see potential benefits of improvements to both formal and informal institutions. The findings of this study did not support the literature's expectation that informal institutions could simply substitute for weak formal institutions: although local informal institutions were found to be vital in facilitating trade, they are currently not strong enough to make up for the substantial weakness of formal institutions. For example, relationships were a complement to rather than a substitute for admittedly weak rule-based dispute resolution. Since this meant that the firms were heavily reliant on their informal resources, an increase in their capacity to form trust relationships could alleviate some of the observed consequences of weak

informal institutions and reduce their trading isolation. However, this would not address the accompanying problems of weak regulatory enforcement. Informal routes around weak formal institutions act as a work-around or a coping mechanism, but cannot improve them; informal mechanisms enable transactions to happen at all in the absence of formal regulation, but cannot contribute to bringing regulations into being. We therefore suggest approaches to improving formal and informal institutions in Chapter 9, and suggest that informal improvements may need to precede improvements to formal institutions.

CHAPTER 9 CONCLUSION

The aim of this thesis, as stated in Chapter 1, was to explore the applicability of transaction cost theory to an emerging market context, complementing it with institutional theory to seek a better fit. This aim was to be achieved by answering three research questions, which asked which causes of transaction costs were perceived by firms, which responses were evident, and whether institutional theory could help to explain firms' responses, if they differed from the predictions of transaction cost theory. The observed gaps in the literature concerned isolation as a response to transaction costs, and the empirical study of informal institutions in China. The author considered this study to be worthwhile because of the increasing recognition in the literature that management theories developed in the West often do not apply well in emerging markets, and because of the constraint that the observed isolation imposed on economic development in these markets.

This chapter will examine the theoretical contributions made by this study, which lie primarily in its recognition of isolation as a response to high transaction costs, and in its integration of transaction cost and institutional theories to identify the pivotal role of informal institutions in determining whether or not firms would become isolated in an environment characterised by high transaction costs. The chapter will then make recommendations for local practice and broader policy as a means of applying the new knowledge gained. It closes with an evaluation of this study, and ideas for future research.

9.1 Theoretical contribution

This section considers the contribution made by this study, in terms of assessing the applicability of transaction cost theory to the research context, and in the increased

understanding of firms' responses that is offered by the integration of transaction cost and institutional theories.

9.1.1 Applicability of transaction cost theory: causes

The research context was chosen to challenge the applicability of transaction cost theory in the light of criticisms that have been made against it. We first consider whether the theory's anticipated causes of transaction costs apply to this context.

Due to the country's Confucian tradition, opportunism might not be expected to be a high risk in China (Dore, 1983). In fact, this was the most widely-reported cause of transaction costs in this study's research site, with the strongest consequences for firms. In this instance, the theoretical expectation of opportunism as a cause of transaction costs corresponds very well to the research context, and Dore's analysis is not borne out in this context. In contrast, whereas Dore criticises Williamson for taking opportunism and bounded rationality for granted, in this particular context we cannot take Confucian values or long-term relationships for granted. Earlier chapters have suggested that the Cultural Revolution (Knight, 2001) or intense competition during the economic reforms of the 1980s (Li, 2008) may have disrupted these traditional patterns of relationships and values.

The strong presence of opportunism puts us in a position of disagreement with Hill (1990), who anticipated that the market would act to remove opportunists through loss of reputation, formalised bankruptcy or takeover. In fact the empirical study observed the situation described by Ghoshal and Moran (1996), where the market creates the need for protection from opportunists, but does not actually provide that protection.

The presence of opportunism, bounded rationality and uncertainty in China corresponds with the expectations of Luo (2007) and Keister (2001). These causes of transaction costs are expected to limit small firms' ability to conduct information search and monitoring, and to increase the risks of trading with a small number of suppliers (Nooteboom, 1993). The participating firms experienced these constraints, but perhaps not exclusively due to firm size, since there was variation in degree. Their difficulties with search, monitoring and suppliers were also related to a shortage of informal connections through which information is exchanged and transactions take place. The expectation that small firms should be protected by their networks from opportunism (Granovetter, 1985) or be able to depend on networks for information (McGee and Sawyerr, 2003) applies in the research site, but only for those firms that already have extensive networks. The applicability of this expectation is limited by the difficulty of establishing or extending such networks.

Neither the literature relating to the Chinese context nor to small firms expects notable transaction costs of specificity or frequency. These are inherent in the transaction, rather than being a characteristic of the context in which the transaction takes place, and are largely beyond the scope of very small firms. They might have applied more closely to the tourism sector in the past, when foreign ownership of local assets was more common (Dunning and McQueen, 1981).

The perception of opportunism, bounded rationality and uncertainty is consistent with generic theory, and with expectations related to the research context. Opportunism was found to have a particularly strong influence on firms' decisions, whereas uncertainty was inconsistent in its effect.

9.1.2 Applicability of transaction cost theory: responses

We next consider the degree to which the theory applies to this context, in the responses to high transaction costs that it anticipates and the reasoning it offers for them, in comparison to the response of isolation observed in the field.

Williamson (1975) expects firms to reduce the number of market-mediated transactions when transaction costs are perceived to be high. Up to this point our field data agree with the literature, as the firms do reduce the number of transactions they perform. However, Williamson expects this reduction to move transaction from the market into the hierarchy of the firm or a cooperative structure. Transaction costs are at their lowest in simple market exchanges, and when these are still too high, a change of transaction governance is required. Whereas Williamson (1985) considers a move from market to relational exchange to be a deliberate response to transaction costs, in the research site relational trading was found to be the usual starting point for exchange: this is our early indication that the nature of trust differs greatly between Western conceptions and the research site. Although we see some of the governance structures described by Williamson, they are present for different reasons than those he described as being the cause of these structures.

Another divergence is the internalisation decision by firms to bring in-house the production of some goods or services rather than procuring them on the market (Williamson, 1975). As we have discussed in Chapter 6, non-specialised firms were producing many inputs in-house, but this was as a continuation of their earlier farming practices rather than as a deliberate broadening of their range of activities. Again, a snapshot of behaviour appears to conform to Williamson's expected response of reducing transaction costs at the margin, with the broad range of productive activities foreseen by Buckley and Casson (1998), but a closer examination reveals that it has not developed in the manner and for the reasons that

he expected, and instead reflects a decision not to specialise. However, the high level of uncertainty in the research site supports Jones' (1997) expectation that the decision whether to make or buy would be a judgment rather than a precise calculation.

Cooperation between a few participating firms and international tour operators did appear to work as a means of reducing risk and improving market access that was not resource-intensive. This supported the recommendations of Oviatt and MacDougall (2005) and Thorelli (1986), matching closely the needs and capabilities of the participating firms, but left the question why it was not observed more frequently, especially given that cooperation is the expected response to high transaction costs both by small firms (Nooteboom, 1993) and in a Chinese context. Cooperation is also proposed as an alternative to formal governance structures when there is weak (Zhou and Poppo, 2008) or unpredictable (Luo, 2007) law enforcement, which was reported by the participants. The historic preference for relational ties (Zhou and Poppo, 2008) was less strongly in evidence, as participants lacking in social contacts withdrew from trading rather than trying harder to cultivate such ties. Explanations for these surprising findings will be offered in the next section.

The market institutions in the research context were less developed than the level assumed by transaction cost theory: they did not offer effective legal protection from opportunists, which Hill (1990) had expected to be a function of the market, or enable the funding and legal recognition or protection of internalisation. Zhou and Poppo (2008) anticipate that this lack of development will hinder the transition from trust-based to contractual governance in China. The effect of assuming a given level of competence of the regulatory institutions is that the response mechanisms that are predicated on this simply cannot apply. So even though the causes of transaction costs are present in this context, we cannot expect the same response as the literature

predicts, where this concerns increased complexity of contract, internalisation through acquisition, or formalised cooperative alliances.

Instead, we observed isolation as a common response to high transaction costs. Over the course of this study isolation has been developed from a sensitising concept, to describe the tendency towards self-reliant production observed in the exploratory study, to a grounded description of a trading behaviour that relies on personal exchange with a minimal number of customers and suppliers, with little horizontal cooperation. Although the literature hints at the possibility of isolation in response to high transaction costs, this is presented as an exception rather than an anticipated rule. Williamson (1985) concedes that particular transactions might be avoided where extreme uncertainty prevents the drafting of complete contracts; however, our empirical work finds uncertainty to be the norm, and avoidance of transactions a routine means of reducing transaction costs. Zhou and Poppo (2008) only expect transactions to be avoided if opportunism is added to the combination of uncertainty and weak institutions, which they otherwise expect to lead to cooperation. Lyons (1995) and Buckley and Casson (1998) cite specific examples of how suspicion of suppliers or of the market mechanism might lead firms to prefer in-house production, but neither explains the widespread tendency towards self-sufficiency observed in this study. North (1990) describes the absence of both formal and informal enforcement as an extreme case that might lead to the avoidance of exchange.

The theoretical implication is that this study contributes to filling the first gap in the literature: the response of isolation is evident in the simple governance structures, the wide range of productive activities carried out under a single roof and particularly in the limited relationships of some participating firms. This response is also far more common than the brief mentions of it in the literature would suggest, and so merits the degree of attention that this study has paid to it.

Because the analysis did not find a consistent and sufficient relationship between causes of high transaction costs and the outcome of isolation, it incorporated an investigation into the effect of reported strength or weakness of institutions. This will be discussed next, and suggests that the modification to transaction cost theory that would increase its applicability to this context would lie in incorporating the influence of institutional conditions in its assessment of how firms are likely to respond to high transaction costs. Where institutional weakness prevents the expected responses of internalisation and cooperation, the available responses are integration into the market or the newer idea of isolation from it.

9.1.3 Integration of transaction cost and institutional theories

Having examined the broad applicability of the theory's expected causes of transaction costs to the research context, and reviewed the nature and extent of the alternative response of isolation, we now consider institutional factors as a possible contributory cause of this response. Whilst this approach agrees with the many writers who call attention to the importance of institutions to our understanding of decision-making in emerging markets and in China, a distinction between formal and informal institutions (in the language of North, 1994b) has been vital to our exploration of institutions' effect on responses to transaction costs. This extends beyond the extant literature that not only does not consider isolation in depth, but also focuses mostly on the impact of formal institutions on Chinese firms' responses.

9.1.3.1 Formal institutions and responses to transaction costs

The research site did not display the effective formal institutions of law enforcement that North (1994b) and Rao (2003) expect to reduce transaction costs, but more closely resembled Palepu and Khanna's (1998) characterisation of emerging markets whose weak formal institutions lead to higher transaction costs. However, the key

determinant of the participating firms' decisions was neither the regulatory uncertainty that they experienced and that Ang and Michailova (2008) expected to dominate in emerging markets, nor the formal constraints on small firms expected by Morrison et al. (2003). In fact, formal institutions were more notable in this research context for their failure to help reduce transaction costs, than for substantially increasing them.

Whilst Levitsky (1989) had correctly anticipated that government policy would seem remote to small firms, local government was also largely irrelevant to them despite the expectations to the contrary of Smallbone and Welter (2006). In a similar vein, Elkan (1995) and Luo (1997) were right that the firms would not receive government support, but nor were there any reports of the malign government influences suggested by Peng (2004) and Zhou and Poppo (2008). Mechanisms for the legal resolution of disputes were undeveloped as expected (Ahlstrom et al., 2003), but there was less evidence of the informal resolution that both they and Zhou and Poppo envisaged (2008) than of a preference for self-reliance. The levels of reliability of legal description (de Soto, 2006) and enforcement (Zhou and Poppo, 2008) were so low as to make them an irrelevance rather than a hindrance to decision-making. Weak property rights constrained borrowing and so investment (Cleaver, 2007), with a consequent reliance on informal borrowing as expected among small Chinese firms by Peng (2004) and Herd et al. (2010), and an additional emphasis on the reinvestment of profits. It seemed not so much that perverse incentives of dysfunctional institutions were driving up transaction costs, as that their absence failed to deliver beneficial effects. However, the cost of this absence was that Granovetter's (1985) hopes that formal institutions would serve as a functional substitute for trust could not be fulfilled.

A deeper understanding of the weakness of formal institutions in this research context has helped to explain why firms do not respond by more detailed contracts, internalisation and formal cooperation. This does not mean, however, that transaction cost theory with its implicit reliance on strong formal institutions does not apply in contexts with weak formal institutions. On the contrary, it invites a broadening of the theoretical integration to incorporate North's (1990) proposed effect of informal institutions supplementing weak formal institutions, thus avoiding the under-socialised view criticised by Granovetter (1985). The author shares Tremblay's (1998) view that transaction cost theory does not yet fully explain firms' decisions, but whereas he considers technological change to be the missing causal factor, in this context we propose that the factor that has not yet been accounted for is the strength or weakness of informal institutions.

9.1.3.2 Informal institutions and responses to transaction costs

Researchers have recently increased the emphasis they place on the importance of informal institutions to the study of firms in emerging markets (Trevino et al., 2008) and in China in particular (Peng et al., 2008). Zhou and Poppo (2008) and Peng and Luo (2000) expected informal ties to help to offset the impact of weak formal institutions, North (1990) and Madhok (1995) thought that they could moderate the risks of opportunism and uncertainty respectively, and Hu (2007) proposed that norms and trust would facilitate the reduction of transaction costs in China. In the field study, however, rather than the strength of informal institutions reducing transaction costs, their weakness contributed both to raising these costs and to constraining firms' responses to them.

The informal structures within which trust develops were inefficient, increasing the time and cost of development, and hindering its reach. The very first step described by Humphrey and Schmitz (1998) assumes an acceptance of risk in the hope that

partners will not act opportunistically, but the participants did expect to be taken advantage of, and so rather than exposing themselves to the risk of opportunism they developed protective mechanisms. This meant that most instances of trust were interpersonal, developed through acquaintance rather than the description that de Soto (2006) expected to suffice, with the consequences that their reach was limited by the participant's range of personal contacts and a substantial investment of time was entailed in their development. There was very little impersonal trust, so the potential benefits of reduced transaction costs where opportunism is not expected (Rao, 2003) were not realised. In this research site, the ties that were valued for engendering trust were strong: as Granovetter (1973) anticipated, this resulted in isolation, whereas more numerous weak ties would help to expand the range of their networks. Trust relationships preceded business relationships, as expected in China (Zhou and Poppo, 2008). Both of these restrictions contributed to the difficulty experienced by participants in expanding their networks of trust relationships, which Keister (2001) describes as the path-dependency of trading relationships in China. The opportunities for trust and networks to substitute for weak formal institutions, and to reduce transaction costs, were consequently less common than expected in China (Buckley, 2004, Hu, 2007). Storper's (1991) warnings of trust serving as a private means of market coordination to the exclusion of new entrants, were borne out by the empirical findings of this study: trust could protect the transactions of those who were already party to it, but constrained the trading activity of others.

Peng's (2004) imagery of concentric circles of relationships proved to be apposite in this context, with kinship often restricting employment and social ties being the strongest determinant of trading partners. Fukuyama's (1995) concern was that this restriction on employment would hinder internalisation in China, but the lack of a driving need and of enabling resources for internalisation (Granovetter, 1985) in the research site have perhaps been greater blocks. The effect of social ties in facilitating

trade worked through their role as a locus of close trust (Hu, 2007) rather than in extending the reach of cooperation and deterrence of opportunism as Peng (2004) had hoped. It was this limited scope of participants' networks that so reduced their effectiveness, compared to the high expectations raised by many writers in the literature specific to China. The usefulness of political ties anticipated by Li et al. (2008b) was out of the reach of most participants, just as the government itself was too remote to constitute an immediate concern to them. Luo's (2008) prediction that the Chinese would hold increasingly negative views of such ties was supported by the critical opinions expressed by participants.

Given that the participants expected their trading partners to behave opportunistically, the author had anticipated that Humphrey and Schmitz's (1998) conception of sanctions designed to deter such behaviour would be appropriate to the site. However, sanctions were not used as an informal enforcement mechanism even though Peng (2004) and Zhou and Poppo (2008) expected this to be effective in China, and Holstrom (2002) had explained their usefulness to locally-based groups. This failure to employ sanctions may be due to ethnic or other differences hindering participants' propensity to recognise a shared common interest (Ostrom, 1990), intensifying competition and then further obscuring the recognition of a shared interest; alternatively, it may be due to norms of village life preventing the free communication of infractions that is vital to the operation of sanctions (Douma and Schreuder, 2008).

This increased understanding of informal institutions in the research context has helped to explain why even informal cooperation is little used in response to high transaction costs. In an environment of weak regulatory enforcement, transacting parties' minimal recourse to outside protection of even an informal nature has confined many firms to personal exchange. This constraint is reinforced by the

weakness of institutional support for the development of trust and informal governance structures, with the result that isolation is commonly seen as the only rational response to the transaction costs caused by opportunism, bounded rationality and uncertainty.

9.1.3.3 Contingent effect of institutions on firms' responses

Institutional theory is expected to help to explain firms' decisions whether or not to cooperate in response to high transaction costs, for example by North (1990) in general, and by Li et al. (2008b) in China. Roberts and Greenwood (1997) considered both formal and informal institutions as constraints on firms' responses to transaction costs. The findings of this study are consistent with these views, but they also reveal a greater significance of the role of informal institutions that were identified as a necessary condition in the fsQCA analysis. Although our interview data showed weak formal institutions hindering contract, internalisation and formal cooperation in response to high transaction costs, the fsQCA analysis also found matched cases where the strength or weakness of formal institutions made no difference to the outcome of isolation. This brings our findings closer to the expectations of Oliver (1991) and Martinez and Dacin (1999), who emphasised social constraints on firms' decisions and their quest for transaction cost efficiency.

The necessary condition applied to both the presence and the absence of the outcome: weak informal institutions were associated with isolation from the market, and strong informal institutions with integration into the market. Only one case managed Rao's (2003) recommendation of cooperating in order to overcome high transaction costs, and so avoiding isolation. The analysis of paired cases in Chapter 8 compared this integrated case to another case with similar causal characteristics but a different outcome, and to a further case with different characteristics but the same outcome, to explore whether contingent causality was at work. The cases with

similar characteristics differed on only the reported strength of informal institutions, which appears to account for their different outcomes, and this was interpreted as the critical factor enabling the former case's greater ability to develop new trust relationships to support impersonal trade. The cases with similar outcomes had very different causal characteristics, except for strong formal institutions and a similar ease in developing trust. This shows that the observed contingent effect of informal institutions is critical to avoiding isolation in cases with high transaction costs, and that isolation can be associated with weak informal institutions even when transaction costs are lower. It also accentuates Peng and Luo's (2000) observation that less competitive firms may be more dependent on informal ties, by illustrating the disadvantage posed by weak informal institutions even when a firm's transaction cost and formal institutional position is relatively favourable, and it offers a means of addressing this disadvantage. The pivotal role that informal institutions could play in the reduction of firms' disadvantage and isolation feeds into the main contribution of this study.

9.1.3.4 Possible reasons for the scarcity of trust and weakness of informal institutions

The key contribution of this study to assessing the applicability of transaction cost theory to this research context is its detailed exploration of local institutions that uncovered the severe constraint placed on trading and cooperation by weak informal institutions and especially the scarcity and slow development of trust. That does not simply constitute a mismatch between Western theory and Chinese cultural reality, as the ideas of many Chinese specialists have also been found to have limited applicability in this particular context. It thus appeared that a further, underlying causal mechanism might be at work, which had not been fully explained by the reviewed literature on Chinese business practice.

An important lesson for non-native learners of Chinese is understanding that expressions proceed from the general to the specific. For example, in personal introductions the family name (the general identifier) is given before the personal name (the specific identifier), and dates are expressed as “year, month, day”. The author proposes that the observed patterns in the development of trust in the research site also proceed from the general to the specific. However, whereas Western business practice provides for a pattern of generalised trust in which parties’ trust in counterparties to a transaction is supported by their reliance on the commercial regulatory framework, and distrust of specific individuals may be learned through bad experiences, the research participants in contrast appeared to begin from a general position of distrust of all others, from which specific individuals could earn trust through long-term relationships. The transaction costs of opportunism, uncertainty and bounded rationality in the Western rule-based pattern are borne by the society establishing the rules that enable all members to generally trust all others, whereas the model described for the research site burdens individual traders with all the costs of relationship development. Douma and Schreuder (2008) describe this apportionment of the costs of rule-based transactions as high fixed costs borne by the society but low marginal costs borne by the individual, compared to relationship-based transactions with lower fixed costs but higher marginal costs.

In the future, a transition towards rule-based exchange and more generalised trust could lower the transaction costs of avoiding opportunism, and so enable freer impersonal trade (Arora et al., 1996) and reduce the need for cooperation and internalisation as responses to high transaction costs. This in turn could facilitate specialisation of productive activity with its associated benefits for local economic development (de Soto, 2006). Suggestions as to how such a transition could be initiated from specific trust to generalised trust, and relationship-based to rule-based exchange, will be discussed in the following sections that make recommendations for

policy and practice. Consideration will then be given to recent contributions to the development economics literature, which caution against attempts to introduce international best practice in formal institutional reform without regard to local context.

9.2 Recommendations for policy and practice

9.2.1 Rationale for recommending changes to policy and practice

The status of all the case firms as going concerns shows that their approach of isolation can be commercially viable, but this may be considered to be sub-optimal for reasons that are supported by the literature. Firstly, isolation hinders the transition from personal to lower-cost impersonal exchange (North, 1994b), with its requisite transition from personal trust in the counterparty to an impersonal trust in formal institutions (Douma and Schreuder, 2008). This in turn prevents the further contribution to business and local economic development that could arise from specialisation (Arora et al., 1996) and deeper market integration (Storper, 1991). This would matter in any economy that sought growth, but is particularly pertinent to China, which relies on private enterprise to contribute substantially to its economic growth (Peng (2004) cites the Fifteenth Party Congress of the Chinese Communist Party in 1997 as the first official recognition of this) and will therefore need to foster its development.

There is thus a real need to avoid isolation as a response to high transaction costs, and the institutional weakness that hinders the development of trust relationships has been identified as the criterion upon which this response depends. The first aspect of our recommendations will therefore focus on the development of trust at the firm level, to extend the scope of personal exchange. The second aspect of our recommendations seeks to reduce the transaction costs to which the firms respond,

by strengthening the enforcement of formal institutions. If this were to prove effective in the development of generalised trust, and for the enforcement of rule-based, impersonal exchange, this could reduce the need for reliance on personal exchange, and be of benefit to a broader population of firms. However, because our findings have shown informal institutions to be of critical importance to overcoming high transaction costs and avoiding isolation, we further propose a third option. This builds upon an emergent strand of literature that begins to address an implicit assumption that development policy need only be concerned with formal institutions, and that this can be divorced from the context.

Our proposal of recommendations concerning the weakness of both informal and formal institutions corresponds to the equifinality of the fsQCA solutions: there may be more than one possible means to achieving the desired outcome. Our discussion proceeds with recommendations for local practice, followed by policy recommendations concerning formal and then informal institutions.

9.2.2 Recommendations for business practice

We focus here on firms' business practices that contribute to their responses to high transaction costs, rather than on the external environment over which small firms exercise little control (Smallbone and Wyer, 2006). So without yet tackling the causes of transaction costs, this section proposes a possible means of reducing the degree of isolation that results from them by focusing on the problem areas highlighted by the fsQCA solutions (Schneider et al., 2010, Pajunen, 2008).

Our recommendation is that the participating firms should attempt to broaden the networks within which they develop trust. This is intended as a way of extending the range of trust relationships within which they conduct personal exchange, to increase their integration into the market. It is a coping strategy they could employ themselves

to counteract the isolation caused by high transaction costs, as increased trust between firms could reduce the constraint on trading of the fear of opportunism (Sengenberger and Pyke, 1992), and thus enable them to contribute more to local development (Humphrey and Schmitz, 1998). Such a change to practice could contribute to integration and specialisation whilst the firms remain small (Locke, 1996), rather than pushing them towards internalisation and extension of their boundaries. Smaller scale can be an advantage in sectors that are labour- rather than capital-intensive (Fukuyama, 1995), and in customer-facing service industries (Hausmann and Rodrik, 2006) including tourism (Novelli et al., 2006), in addition to being more appropriate to the rural environment of the research site. For firms that have not specialised out of farming, this could be turned to their advantage: only two participants' menus currently mention that the food they serve is organically grown on the premises, but this could attract more customers if they were to publicise it more widely.

9.2.3 Mainstream recommendations for policy

This section offers a policy recommendation that is consistent with the literature that is currently mainstream, which recommends the adoption of formal institutions in keeping with international best practice. It shows how such advice could be applied in this context, if it were considered to be the best option. It will be followed, however, by a third alternative.

This is a recommendation for government at the national level, in its role as regulator rather than as economic agent or strategic planner (Bennett, 2006), as the latter two roles are not substantially constraining the participating firms and so are not our policy priority. Intervention should not be on behalf of specific firms (Bennett, 2006) or sectors (Hausmann and Rodrik, 2006), but at the aggregate level to encourage economy-wide development. This would, however, require a departure from the

usual Chinese approach of targeting sectors and individual firms (Hong Kong Trade Development Council, 2005). Our aim is not to instruct governments on how to build stronger institutions, which has its own body of literature (see for example North, 2003), but rather to indicate which areas could beneficially be changed.

The recommendation is that policy steps should be taken to strengthen the regulatory regime and its implementation, in order to improve the local business climate. The aim of this would be to extend formal legal protection to reduce the risks of exchange that currently cause high transaction costs. With more consistent regulations and more reliable enforcement, the current need for reliance on personal exchange could be reduced as firms discovered the freedom and protection of rule-based exchange (North, 2003, Peng, 2003, Danis et al., 2010) – if this were to prove viable in the presence of the weak informal institutions. As institutional protection is the foundation upon which impersonal trust is built and generalised across the society governed by these rules, this increased protection could contribute to an increase in the division of labour and the consequent specialisation (Seabright, 2004).

This recommendation is supported by a consensus view in the literature that it is the role of governments to provide the economic and legal institutional framework for business. For example, North's (1994b) particular focus is the provision of the requisite formal institutions for specifying and enforcing exchange, which is supported by Rao's (2003) concern for the institutional structures that affect the level of transaction costs; Olson Jr. (1996) specifies the responsibility for providing a sound legal system to enforce contracts and protect property rights. In the context of emerging markets, emphasis is placed on government responsibility for the institutional conditions that can enable or constrain entrepreneurship (Smallbone and Welter, 2006), the transaction costs of inefficient markets (Palepu and Khanna, 1998), and the regulatory protection of vulnerable consumers (Karnani, 2010). Since

our recommendation can only be enacted by the government, it also follows the caveat that policy interventions should not duplicate or crowd out market provision

(Hausmann and Rodrik, 2006, Rao, 2003, Bennett, 2006 - citing Keynes, 1926). In keeping with this, Chapter 6 suggested that the local government should improve the provision of credit information to banks to facilitate their lending, instead of offering credit guarantees of its own which risk crowding out the nascent market-based lending.

If this recommendation were to be adopted, it could be carried out as a stand-alone exercise in economic reform, or as a focused extension of an existing programme such as China's current New Socialist Countryside rural development policy. "Making Markets Work for the Poor" (M4P) is an example of a market-based approach to economic development currently employed by the UK's Department for International Development (DFID) and the Swiss Agency for Development and Cooperation (SDC), which could be employed as a policy extension. Similar approaches to addressing market inefficiencies are used by the United Nations Development Programme (UNDP, "Growing Inclusive Markets"), Inter-American Development Bank (IADB, "Opportunities for the Majority") and the International Finance Corporation (IFC, "Next Four Billion"), and all correspond to the growing business interest in the Base of the Economic Pyramid initiated by C. K. Prahalad in 2004 (DFID and SDC, 2008b). M4P recognises the importance of efficient markets for economic development. A wide range of analyses is employed to identify market imperfections, including regional economic studies, regulatory reviews and value chain analyses. An economic application of the M4P approach (DFID and SDC, 2008a) interprets the inefficiencies as transaction costs, to be reduced by development of formal institutions in areas including accountability, enforcement and coordination. This is intended to result in systemic change to the benefit of all

market participants, with higher relative benefits accruing to participants who suffer proportionately higher transaction costs. The author considers the present study to complement M4P's broad areas of regulatory effectiveness and improved enforcement mechanisms, which currently lack detail in terms of both analysis and resolution (Meyer-Stamer, 2006).

This approach is considered to be appropriate to an aim of formal institutional reform in this research context, because M4P evolved out of the Sustainable Livelihoods Approach (SLA). SLA was the basis of DFID programmes from 1998 until 2002, when the DFID's focus moved from the symptoms of weak development to attempts at larger-scale resolution of its causes by increasing market participation (Clark and Carney, 2009). SLA is currently used as the basis for research and policymaking at China's Centre for Integrated Agricultural Development in Beijing (Zuo, 2009), confirming its suitability to the context of rural China, and suggesting that M4P or other market-based approaches could be applied to this context in the future.

9.2.4 An alternative approach to policy recommendations

Our concern is that a mainstream policy recommendation such as that outlined above might be of limited effectiveness, because this study's research context adds an additional constraint of weak informal institutions. This seems not to be taken into consideration normally – in either the type of programme described above, or in the literature that follows. The current policy-oriented literature appears to contain an implicit assumption that institution building for economic development concerns only formal institutions to the exclusion of informal institutions (contrary to the advice of North), and it has until recently considered this in generic terms rather than in relation to the local context.

9.2.4.1 Background

The policy recommendations for enabling economic development have moved on from a focus on relative prices in the 1980s, to the realisation in the 1990s that reform of market-supporting institutions was also required in order to shape appropriate incentives (Rodrik, 2000). At the turn of the century, the recognised challenge was to identify which institutions were important for economic growth (Henisz, 2000). At that time, Henisz concentrated on political constraints such as a government's credible commitment to protecting property rights, whilst Rodrik (2000) focused on the formal institutions of property rights, market regulation, macroeconomic stabilisation, social insurance, political representation and the rule of law, all drawn together in a participatory democracy. Over time this was distilled down to property rights and the rule of law (Rodrik et al., 2004, Acemoglu and Johnson, 2005), still echoing North's "rules of the game" (1990: 3). However, a note of caution also emerged, with the observation that these recommendations had become oversimplified – leading to their interpretation as a uniform need for governance reform – and that there was a need to identify the "binding constraint" on growth that was particular to any given context at any given time (Rodrik, 2004: 5). Rodrik further developed this concern for context-specificity with ever-stronger warnings against attempts to copy a "blueprint" of Western institutional best practice into developing countries, regardless of their individual binding constraints (Hausmann and Rodrik, 2006, Rodrik, 2008) – a practice that he associates with multilateral organisations including the International Monetary Fund, World Bank and World Trade Organisation.

At the same time, the study of government institutions remained focused on curbing the power of political elites through stronger property rights protection (Acemoglu, 2006, North et al., 2007, Acemoglu and Robinson, 2008). The only observed inclusion of informal institutions in the consideration of policy is in Rodrik's (2008)

counter-argument that there may be more than one way of achieving growth (reflecting equifinality), whereby existing, context-specific “second best” institutions might be more appropriate than acontextual best practice recommendations, which could have counterproductive effects. He supports this idea with the example of informal, trust-based, relational contracting that is used as an effective substitute for weak formal contract enforcement in Vietnam, and warns that imposing best practice would undermine this substitution. He criticises the best practice approach for imposing its model “without paying attention to potential interactions with institutional features elsewhere in the system” (p2). We consider his view to relate closely to the observation we made in the closing summary of Chapter 6, that corrections ought not to be proposed to individual aspects of the trading environment without taking the wider institutional environment into account, and we would suggest that further development of the emerging interest in informal institutions and context would make a useful extension to the policy literature.

9.2.4.2 Application to this study

In the research context of this study, we found that it was the informal, rather than the formal, institutions that explained whether or not firms were able to avoid isolation in the presence of high transaction costs. This interaction effect suggests that the presence of weak informal institutions might reduce the effectiveness of policies that aimed only to address weak formal institutions. We consider this to offer empirical support to Rodrik’s emergent concern both for context-specificity, and for the inclusion of informal institutions, in the formulation of policy recommendations.

In this research site, firms are dependent on a limited number of strong ties (Granovetter, 1973) and become isolated. The M4P or multilateral organisations’ approaches outlined above would seek to replace these informal, relational ties with

strengthened formal institutions. The alternative that we propose as a closer fit to this context would be to facilitate the development of weak ties between more firms, to enable them to establish more numerous relationships within which exchange could take place. Despite North's warning that informal institutions change very slowly, a policy mechanism of public-private institutions has been conceptualised by Hausmann and Rodrik (2006), and given empirical support by McDermott et al. (2009). The broad aim of the former authors was the pooling of public and private capabilities, and shaping incentives to increase productivity. The application of the latter authors was a comparison between two of Argentina's wine-producing regions, which were originally characterised by weak formal institutions and socio-economic fragmentation (approximating to the isolation in our research site). The authors drew upon the work of Locke (1996) and Ostrom (1999) to explain the local government's provision of "bridging structures [in a context where they] are not historically or organically present" (McDermott et al., 2009: 1274), in order to overcome the barriers to acquiring new information that had previously been posed by the participating firms' embeddedness in insular, local networks of strong ties – and which could equally well describe the context of the Tiger Leaping Gorge. These structures enabled "public and private actors create new institutions with governance principles that anchor new horizontal ties among previously isolated producer communities" (p1276), where the resulting new ties between communities were effective in overcoming these barriers to knowledge exchange.

In the present research context, the public element of the partnership would be necessary not only to facilitate, but also to legitimise, the intended bridge-building activity. Legitimation is needed because of the very limited freedom of association reported by participants in the exploratory study. The role of facilitator is needed because of the absence of other bodies, such as local trade associations or chambers of commerce (Locke, 2001), that might otherwise administer such a programme on

behalf of the government. The aim would be to reduce firms' isolation by increasing their range of weak ties and thus expanding their trading networks, whilst also reducing the intensity with which the ties need to be cultivated. In the light of the critical role that informal institutions play in this research site, we have come to consider the reduction of firms' trading isolation to be a more appropriate aim than the Northian goal of impersonal exchange. In terms of costs and benefits, the cost of implementing the policies required for a transition to impersonal exchange in the context of this sparsely-populated rural area, risk exceeding the benefits if the weak informal institutions reduce their effectiveness. A smaller-scale benefit, but with more proportionate costs, would be an expanded range of less close trading partners, allowing firms to make some progress towards specialisation, market integration and contribution to local economic development.

These recommendations are illustrated in Figure 12 below, which is the fourth and final flowchart in the series, and superimposes our recommendations onto the third flowchart. To aid clarity of presentation, we have removed the factors whose importance already appeared reduced in the third flowchart, and shaded out the existing causal path. Our new recommendations are marked in numbered, bold italics and with dashed arrows. Following an outcome of isolation, there is a need (1) to increase trust. The first and third recommendations, concerning informal institutions (2), are marked with dotted arrows; the second recommendation for formal institutions (3) is marked with evenly dashed arrows. The anticipated effect of all three is increased generalised trust (4), with consequences marked with unevenly dashed arrows from (5) reduced transaction costs and increased trade to (6) the possibility of greater specialisation and contribution to economic growth.

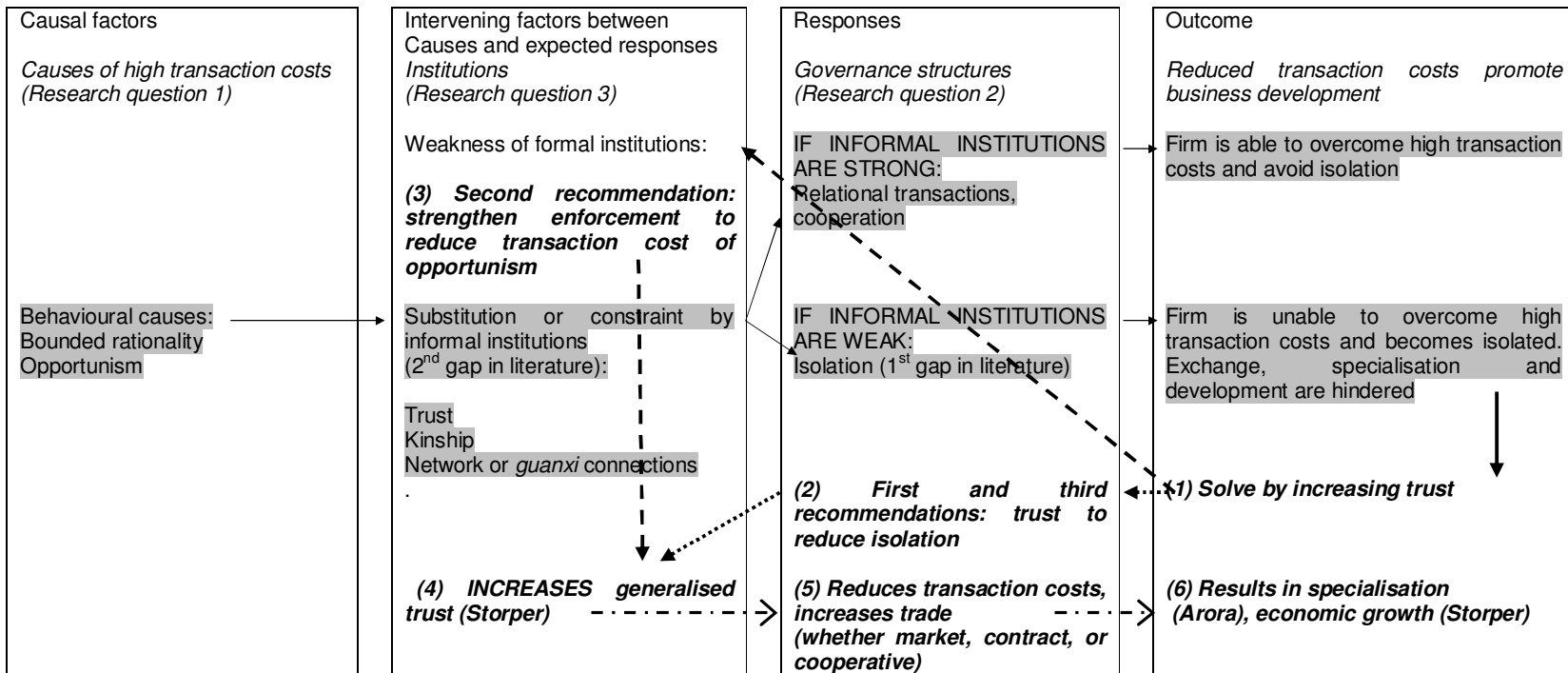


Figure 12 Flowchart 4 – Recommendations for policy and practice

(Source: author)

9.3 Evaluation of the study

9.3.1 Evaluation of theoretical contribution

We believe that our findings avoid the parallel pitfalls of the over- and under-socialised explanations that Granovetter (1985) warned of. The participating firms demonstrate competitive economic behaviour and are influenced by formal institutions so social explanations have not been privileged over economic explanations. Although the firms are even more strongly influenced by informal institutional factors, these were found to be necessary but not sufficient for the outcome, and so did not overshadow the formal factors.

This study has confirmed that transaction cost theory could not be simply transferred across to China, as warned by Leung et al. (2009). But whereas earlier writers have tended to focus on the effect on firms' responses of formal institutions, our exploration has found both formal and informal institutions to be important and has further uncovered the greater importance of informal institutions

We feel that our sharpened focus on behavioural transaction costs and the influence of informal institutions has offered an answer to the challenge, issued by Meyer and Peng (2005), to seek a deeper understanding of the limitations of transaction cost theory. These can be overcome, with reference to this research context, if we add a response of isolation and include the institutional context as a factor influencing firms' choice of response.

This thesis contributes to theory by highlighting the pivotal role of informal social structures on the cost, extent, or even absence of exchange, and thus adapting transaction cost theory to better fit this institutional context. The possibilities for generalisation to other contexts are outlined below.

9.3.2 Generalisation to other emerging market contexts

The recommendations for policy and practice were derived from a generalisation to the theoretical proposition of a relationship between transaction costs, institutions and isolation, in contrast to generalising from a sample to a population (Yin, 2003). This is a moderatum generalisation (Williams, 2000) that interprets aspects of the observed behaviour as instances of a broader set, enabling tentative comparisons. Such a generalisation is in keeping with the critical realist foundation of the study, with its inherent emphasis on studying phenomena in context, and so the external validity of the study (in terms of its transferability to other contexts) has not been compromised (Bryman, 2008). The conclusions drawn from this proposed relationship might therefore be cautiously applied to firms in other emerging markets that share some of the observed institutional weaknesses, whose resolution could facilitate exchange and further economic development.

The reasons for caution in generalisation stem both from the methodology employed by this study, and from the nature of its subject. Generalisation from interpretive research must be more cautious than that based on probability samples, which may make inferences to a population (Williams, 2000). Such statistical inference is not the aim of QCA so much as assisting causal interpretation (Ragin, 2005b), and these interpretations should be generalised to cases considered to be similar to those in the QCA analysis (Berg-Schlosser et al., 2009). We therefore adopt the view (Zhou and Poppo, 2008) that attempts to generalise from China to other emerging markets should take the form of further research to explore which characteristics are shared, rather than assuming that any or all will be shared.

9.3.3 Evaluation of methodological contribution

The examples given in Chapter 5 showed the QCA approach to be less commonly used as yet in business research, than in its more established fields of social and political science. It is an even more recent addition to international business research, with only two articles (Pajunen, 2008, Schneider et al., 2010) in the *Journal of International Business Studies*. The method is used extensively in the comparison of quantitative data sets, but despite the value that Ragin (2000) places on the interpretive value of fuzzy sets derived from interview data, there are few published examples of this. The closest that the author has found is the re-analysis by Haegel (2007) of data from structured interviews, observations and documentary evidence that were collected for a predecessor's exploratory research. The author therefore considers the analysis of interview data to be a novel contribution both to QCA in general, and to its application in international business research in particular. It has been effective in answering the research questions, maintaining the strong connection to the research context, and for uncovering the importance of the underlying process of trust formation.

The author further feels that although the analysis has progressively reduced the detailed interview data down to a series of numeric scores for computer-assisted analysis, this process has not diminished the richness of the analysis. This is firstly because a thematic analysis was conducted on the interview data, relating detailed findings to the literary sources that had prompted the interview questions, and secondly because the analysis of the fsQCA solution has entailed frequent reinterrogation of this detailed data, in what Ragin (2000: 4) describes as a "dialogue between ideas and evidence".

Finally, the isolation that was observed during the ethnographic reconnaissance of the exploratory study was a concept still fairly new to the literature. It seems,

however, unlikely that this is a new phenomenon, and more likely that it is a more common occurrence that International Business data collection methods have largely overlooked. We therefore consider that the method of observation used to collect the data for this study has also made a contribution.

9.3.4 Data validation

The interview data were validated by triangulation at various levels (Ghauri, 2004): amongst cases, between cases and context interviews, between both parties to a business relationship, between similar questions asked of the same participant, between the methods of interviewing and observation, and from data to theory. This was intended partly to increase confidence in the findings, but mostly to highlight areas for further investigation where different parties reported varying perceptions, and to uncover asymmetric power-relationships. It was not intended to identify and dismiss non-conforming data, which would have contradicted the abductive approach (Blaikie, 2000).

The study meets standards adapted specifically for qualitative research (Lincoln and Guba, 1985), for example: credibility is demonstrated by the author's long-term association with the field site, analytical generalisability has been shown in the close link between the literature and the research context, and consistency is apparent in the documentation of stages in interpretation. Internal validity was enhanced by the author's repeat visits to the field site, which contributed to a deeper understanding of the setting and responses (Lapsley, 2004, Mason, 1996). The reliability of interpretation was maximised as far as possible by the choice of language for each interview, and the use of multiple questions to confirm the understanding both of the participants and of the researcher. The analysis is reliable in the sense of replicability (Bryman, 2008), as the coding and fsQCA procedures have been thoroughly documented; an attempt to replicate the data collection would, however, not

necessarily succeed in collecting the same subjective interpretations from the participants (Lincoln and Guba, 1985). The risk of inconsistency in the coding of these data was reduced by the establishment of benchmarks, and by frequent cross-checking between cases during coding.

Maintenance of the researcher's objectivity during data collection (Lofland and Lofland, 1995) was assisted by her role of outside researcher, as this maintained a guest-host relationship in addition to the researcher-participant relationship. The researcher also moved between guesthouses at least every two days, which avoided excessive immersion in a single firm. The reliability of analysis (Silverman, 2005) is supported by comprehensive documentation of analytical procedures, and the use of a systematic, computer-assisted method. It is also increased by the empirical grounding of the research questions in the exploratory study (Peräkylä, 2004) and in the literature.

9.3.5 Limitations

The contributions made should be qualified by the limitations of this study. The participating firms were the accessible population of the selected study site, which has meant that the final research question was shaped around the concerns common to this site, and restricts generalisation to other comparable sites. On the other hand, this had the advantage of grounding the research in the issues experienced by the participants, and avoiding the limitations associated with sampling. It further facilitated the inclusion of comparable cases, which would have been more difficult to ensure if the cases had been drawn from multiple sites or contexts.

The number of cases in the study was appropriate to the types of analysis employed, and enabled the collection and analysis of very detailed data. If detail had been sacrificed in favour of more numerous participants, this could have enabled the

drawing of statistical inferences. Most firms could provide only one interviewee, which prevented comparison within cases. Comparison was instead made amongst cases, and between cases and context interviews, as described above.

One aspect of reporting on the study that the author feels has reduced its immediacy to the reader, however, has been the need to protect the anonymity of the participants. QCA demands a detailed knowledge of the cases, which the author has attempted to impart to the reader but which has no doubt been hindered by the author's deliberate attempt to disguise the participants' identities. Furthermore, certain characteristics of individual participants would usefully contribute to the analysis of their strengths and motivations, but could not be included in the discussion because they would have offered an obvious connection to the identities of the participants in question. The author therefore offers assurance that where participants had such distinguishing features, they have been found not to outweigh the openly discussed similarities and differences between cases, so no unique but undisclosed features have determined the outcome of the analysis.

The exploratory nature of this study has yielded a broad understanding of many factors, and identified those that are of most importance to the outcome. A deeper understanding of why these latter factors arise and how they operate would need to be the subject of a future study focused more closely upon them.

9.4 Future research

As indicated above, the limitation of the wide scope of the current study opens up the possibility of a more tightly-focused study in the future. Having laid the foundations for integrating transaction cost and institutional theories, the findings of the current study could form the basis of a subsequent study specific to the factors that have emerged as the most important: opportunism, enforcement and the development of

trust. This could take the form of a more in-depth comparison between two opposing cases in the manner of McDermott et al. (2009), to identify further lessons that cases without trust could learn from those with trust – both here and in other emerging market contexts. Alternatively, the data collected for this study could be used in the coding of new fuzzy sets, for just those elements that contribute to opportunism from amongst the transaction costs, and trust from the informal institutions.

The negative case, P6, would merit deeper study. There may be further factors contributing to her successful avoidance of isolation despite the disadvantages of high transaction costs and weak institutions, which were not included in the original study. If her flair for managing relationships with customers, tour operators and competitors can be associated with another marked difference from the other firms – perhaps in her motivation as an entrepreneur, which might be through choice rather than necessity (Reynolds, 2001) – this insight could be of value in suggesting how other firms could also avoid isolation.

Follow-up studies with more numerous cases could be designed to serve a number of purposes: to enable an fsQCA analysis without the need for counterfactuals; to seek broader support for the idea of an interaction effect, if more cases were found that integrated despite high transaction costs or were isolated with variable transaction costs; to try out the emergent idea of generalised distrust and specific trust; or to explore whether this appears to be associated with particular ethnic groups. A second study of the same participants could add an informative longitudinal aspect to the study: as all of the participants were first-generation founders, a return to the research site by the author in ten years' time could compare the perceptions, responses and degree of specialisation of the next generation of proprietors. In order to explore any relationship between rural/ urban location and the development of informal institutions, a comparative study could be designed with the addition of an

urban site in the same region. This could be the town of Zhongdian, which has a similar ethnic mix to the Tiger Leaping Gorge and a growing urban tourism industry, or the more mature tourist destination of Lijiang, a UNESCO World Heritage Site to the South of the gorge.

In much broader terms, comparative studies with similar sectors in other emerging markets could assess the generalisability of the conclusions. Comparable cases might range from the established trekking routes in Nepal, to the nascent provision for tourists in the rural north of Vietnam – the country where Rodrik (2008) found relational contracting to be effective. Further generalisation could draw on a comparison drawn with small firms in a different industrial sector.

Building on the findings of the current study, a detailed follow-up study could further aim to investigate what causes the weak informal institutions, perhaps in connection with the Commons literature. For example, Ostrom's (1992) characterisation of communities that are able to develop endogenous solutions to common-pool resources share similarities with the participants of the current study. The group is small and stable, and – within the limited extent of existing trust relationships – they share norms of trust and have low information costs; they also value the continuation of their activities. The key difference may lie in the interaction between the community and the government: Ostrom sees an optimum involvement where authorities lower the transaction costs of reaching community agreements and the ability of individuals to enforce them, rather than by imposing rules from outside. This takes us again to a future role for public-private organisations as suggested by Hausmann and Rodrik (2006). A related broadening of the disciplinary approach could extend this study into the field of developmental entrepreneurship, or into economic development policy – taking further the ideas of bringing informal institutions and local context into the formation of policy recommendations.

In conclusion, the author considers that the study has achieved its aim of adapting transaction cost theory to more closely apply to this research context. It has shed new light on the processes by which trust relationships are formed, and the constraints that this places on aspirations for wider, less personal and more specialised trade. This may lead to further conceptual development in this area in addition to the dissemination of suggestions for policy and practice, both of which could be of great significance to enterprise development in China and further afield.

APPENDIX 1: Link from theory to interview topics and fuzzy sets

All 82 fuzzy set codes are listed below. The method of coding the set scores is described in Chapter 7.

Research question and concept	Literature review paragraph number	Related citation	Indicative interview questions	Fuzzy set code	Description of fuzzy set – Set of cases with:
RQ2: Responses to transaction costs					
Organisational structure	2.3.2 Organisational structure	Williamson, 1985 Thorelli, 1986 Rao, 2003	Do you have, or can you imagine, ownership, partnership or formal cooperation with other firms? Can you imagine taking over a supplier, or being taken over by a tour operator?	21A4	Company structure without internalisation or cooperation
	2.3.4 Responses in context	Oviatt and MacDougall, 2005 Nooteboom, 1993			
	2.3.1 Governance of individual transactions 2.3.4 Responses in context	Williamson, 1975 Williamson, 1985 Zhou, Poppo and Yang, 2008	Do you conduct arm's length market transactions? Relational trading, cooperation?	21E1	Transaction governance is relational, not arm's length
Specialisation of activities	3.5.1 Market institutions and specialisation	North, 1990 Buckley and Casson, 1998	Which tasks are performed in-house or outside? Would you say you have specialised? Has this changed over time?	22F5	Non-specialised, is a generalist in-house producer
	3.5.1 Specialisation	Lyons, 1995 Buckley and Casson, 1998	Do you prefer to make rather than buy because of a fear that suppliers might starve you of inputs? Would you switch from make to buy if purchasing costs fell or production costs rose?	22F10	Not specialised because of supply risk
	3.5.1 Specialisation	North, 1990	Is it safer not to specialise? Why? Is it like insuring against an uncertain future?	22F11	Not specialised as insurance against uncertain environment

Research question and concept	Literature review paragraph number	Related citation	Indicative interview questions	Fuzzy set code	Description of fuzzy set – Set of cases with:
	3.5.1 Specialisation	Ellis and Biggs, 2001	How many sources of income do you have? Why just one/ many?	22F13	Multiple income sources
Isolated from relationships	3.5.2 Trust and informal constraints	North, 1990 Granovetter, 1985	How many suppliers do you buy from, are they local/ remote, how often, what volume? Relational or arm's length?	23D1	Limited number of suppliers
	3.5.2 Trust and informal constraints	North, 1990 Granovetter, 1985	How many regular or ad-hoc tour operators? How many individual guests?	23D0	Limited number of customers
	3.5.2 Trust and informal constraints	North, 1990 Zhou and Poppo, 2008	For how long have you traded with suppliers? Does this build trust? Would you buy from a stranger?	23D2	No impersonal exchange in supply
	3.5.2 Trust and informal constraints	Artz and Brush, 2000	What is your relationship with the other guesthouses? Competition, cooperation, disinterest? Trust, suspicion?	23F12	No inter-firm cooperation or cross-marketing
RQ1: Perceived causes of transaction costs					
Specificity	2.2.3 Types	Williamson, 1985 and 1991 Poppo and Zenger, 2002 Langlois and Robertson, 1995 Lamminmaki, 2005	Are any assets dedicated to a specific client/ tour operator? Anything requested by a specific client? E.g. buildings, tailored extensions/improvements, staff members, training received. Are you ever fully occupied by a single client group?	TSH1	Investments to support specific transactions
	2.2.3 Risk of dependence	Rao, 2003	Does this make you dependent on that client? Is that risky? How could you reduce the risk?	TSH6	Dependence on the relationship with specific customers
Frequency	2.2.4 Frequency	Colbert and Spicer, 1995	Do you have high-volume or recurring transactions with the same tour operator?	TFI1	Repeat or high-volume customer transactions
	2.2.4 Frequency	Colbert and Spicer, 1995	Do you have high-volume or recurring transactions with the same supplier?	TFI2	Repeat or high-volume supplier transactions

Research question and concept	Literature review paragraph number	Related citation	Indicative interview questions	Fuzzy set code	Description of fuzzy set – Set of cases with:
	2.2.4 Governance	Williamson, 1985	Do you manage them differently to one-off customer visits?	TFI3	Perceived importance of long-term customer relationship
	2.2.4 Governance	Williamson, 1985	Do you manage them differently to one-off purchases?	TFI4	Perceived importance of long-term supplier relationship
Uncertainty	2.2.5 Perception	Williamson, 1985 Sutcliffe and Zaheer, 1998 Werner, Brouthers and Brouthers, 1996 Wholey and Brittain, 1989 Dess and Beard, 1984 Guiler and Guillen, 2010	Do things happen that affect your firm, but that you can't control or anticipate? E.g. natural disasters, competitors' behaviour, government policy, economic change, supply and demand.	TUJ1	Perception of uncertainty
	2.2.5 Adaptation	Krishnan, Martin and Noorderhaven, 2006 Barthélemy and Quélin, 2006	How do you adapt, respond or plan? Does more detailed contracting help?	TUJ3	Active attempts at adaptation/ response/ contingency planning
	2.2.5 Impact	Keister, 2001	Do you avoid trade because of uncertainty? Does this affect a particular partner? Or many partners?	TUJ5	Avoids trade because of uncertainty
Bounded rationality	2.2.1 Planning	Williamson, 1975	Can you plan? What tasks, timescales?	TBK1	Perceived difficulty of planning due to bounded rationality
	2.2.1 Asymmetry 2.4.2.1 In context	Williamson, 1975 North, 1990 He, 2002	Does the seller have information that you don't? Does this put you at a disadvantage?	TBK2	Awareness of information asymmetry, as a buyer
	2.2.1 Language	Buckley and Chapman, 1998b	In which languages do you negotiate? Can this mean you don't fully understand the transaction?	TBK3	Language hinders understanding of transactions

Research question and concept	Literature review paragraph number	Related citation	Indicative interview questions	Fuzzy set code	Description of fuzzy set – Set of cases with:
	2.2.1 Monitoring	North, 1990 Zhou and Poppo, 2008	Can you monitor counterparty, at worthwhile cost? Would this prevent a contract?	-	[Insufficient responses to code]
	2.2.1 Incomplete contract	Williamson, 1975 Williamson, 1985	What detail would be included in or omitted from a contract? Complex for contingencies, or vague/ incomplete? Renegotiate?	TBK5	Lack of information constrains contracts
Opportunism	2.2.2 Types	Williamson, 1985 Buckley and Chapman, 1998a Wathne and Heide, 2000	Do people ever lie, cheat, steal, make promises they don't intend to keep, withhold or distort information, take advantage of others?	TOL1	Awareness of types of opportunism
	2.2.2 Actors	Schauwecker and Kühlmann, 2007	Have you seen people taking advantage of or cheating customers?	TOL2	Seen it towards customers, by other service providers
	2.2.2 Actors	Schauwecker and Kühlmann, 2007	Have you ever been cheated by your customers?	TOL3	Experienced it by customers
	2.2.2 Actors	Schauwecker and Kühlmann, 2007	Have you ever been cheated by your competitors?	TOL4	Experienced it by competitors
	2.2.2 Actors	Williamson, 1985	Have you ever been cheated by your suppliers? Is there more risk, if you have only a few regular suppliers?	TOL5	Experienced it by suppliers, small n
	2.2.2 Fear	Williamson, 1985	Do you fear that your firm could be taken advantage of by opportunists? Who – customers, suppliers, officials?	TOL6	Fear of cheats
	2.2.2 Judgment	Douma and Schreuder, 2008	Can you judge whether a stranger is honest? How? Is this effective?	TOL7	Inability to make judgment/ recognise opportunists among people they don't already know
	2.2.2 Monitoring, 2.3.3 Combined	Zhou and Poppo, 2008 Carson et al. (2006)	Can you monitor your counterparty, how would you respond or retaliate?	TOL8	Inability to monitor and respond/ retaliate

Research question and concept	Literature review paragraph number	Related citation	Indicative interview questions	Fuzzy set code	Description of fuzzy set – Set of cases with:
	causes				
<i>Consequences</i>	2.2.2 Protection, 2.4.2.1 Context	Zhou and Poppo, 2008 Hill, 1990	Are there social or legal sanctions against cheats? Are they effective?	TOL12	Doesn't feel protected from opportunists
	2.2.2 Personal exchange	North, 2003	Do you know personally all the suppliers you buy from? Do you ever buy from strangers?	TOL9	Trades only with known suppliers
	2.2.2 Constrained range	North, 2003	Why not trade with strangers? Would you trade more widely, if you knew more suppliers personally?	TOL10	Feels constrained from trading more widely
	2.2.2 Risk	North, 2003	Would it be more risky, to buy from suppliers you don't know?	TOL11	Perceive a risk of impersonal exchange
RQ3: Whether institutions help to understand the response to transaction costs					
Informal institutions					
Trust: who is trusted	4.3.2.1 Trust	Peng, 2004 Child and Moellering, 2003 Fukuyama, 1995	Who do you trust?	ITM1	Personal trust limited to kinship network
	4.3.2.1 Trust	Peng, 2004 Child and Moellering, 2003 Fukuyama, 1995 Knight, 2001	Do you trust your close family? Wider family, kinship network? Do you trust your friends, social network? Outsiders?	ITM3	Trust limited to kinship and social network, not beyond
	4.3.2.1 Trust	Lewicki and Bunker, 1996	Do you trust people who are similar to you? Different to you?	ITM4	Trust limited to similar people
	4.3.2.1 Trust	Humphrey and Schmitz, 1998	Can you trust organisations as opposed to people? E.g. other firms, banks.	ITM5	No impersonal trust in firms or formal institutions

Research question and concept	Literature review paragraph number	Related citation	Indicative interview questions	Fuzzy set code	Description of fuzzy set – Set of cases with:
<i>Types of trust</i>	4.3.2.1 Trust	Barney and Hansen, 1994	Do you have any vulnerabilities? Could they be exploited? How do you safeguard them?	ITN1	Weakness (not strength) of trust
	4.3.2.1 Trust	Granovetter, 1973	Do you value long-term relationships? Recent relationships? If they could benefit the firm?	ITN2	Only value long-term relationships, not recent/ weak ties
	4.3.2.1 Trust	Humphrey and Schmitz, 1998	Do you conduct simple trades, trade involving long-term commitment, international cooperation?	ITN3	Minimal (not extended) trust
<i>Sequence in development</i>	4.3.2.1 Trust	Lewicki and Bunker, 1996 Dibben and Harris, 2001 Zhou and Poppo, 2008	Could you trade with someone you don't yet trust? Must trust come first? Can trade help to develop trust?	ITN4	Trust must precede business transactions
	4.3.2.1 Trust	Dibben and Harris, 2001	Is there anyone you used to trade with, but don't any more? Are you still in contact?	ITN6	Ceased trade and lost contact with former trading partner
	4.3.2.1 Trust	Dibben, Harris and Wheeler, 2003	Do you trust people because of your personal disposition? Or determined by situation?	ITN7	Reasons for trust are dispositional (not situational)
<i>Outcome</i>	4.3.2.1 Trust	Steensma, Marino and Weaver, 2000	Does your trust in other people reduce your fear of opportunism? Eliminate it?	ITO1	Personal trust does not reduce fear of opportunism
	4.3.2.1 Trust	Humphrey and Schmitz, 1998 Rao, 2003	Does your trust of institutions and other firms make you willing to trade with unknown parties?	ITO2	Impersonal trust does not enable impersonal exchange
Kinship	4.3.2.2 Kinship	Whyte, 1996 Fukuyama, 1995	Do you employ family members? Wider social network? Outsiders?	IKP2	Employment limited to kin
	4.3.2.2 Kinship	Whyte, 1996 Fukuyama, 1995	Do you buy from family members? Wider social network? Outsiders?	IKP3	Trade (suppliers) limited to kin
	4.3.2.2 Kinship	Peng, 2004	Are you protected from opportunists by family, friends, police? Self reliant, no protection?	IKP4	Not protected from opportunists by kin

Research question and concept	Literature review paragraph number	Related citation	Indicative interview questions	Fuzzy set code	Description of fuzzy set – Set of cases with:
	4.3.2.2 Kinship	Peng, 2004	Can you get help in dispute resolution from family, friends, police? Self reliant, no protection?	IKP7	Does not involve kin in dispute resolution
Networks/ guanxi	4.3.2.3 Networks	Li, Zhou and Shao, 2008b	Does your network have a social aim or business aim? Or both?	IGP8	Social network has a non-strategic aim
	4.3.2.3 Networks	Zhou and Poppo, 2008	Are you accustomed to network- or <i>guanxi</i> -based trade? Would you consider a transition to impersonal trade?	IGP9	Resistant to switch to non- <i>guanxi</i> transactions
<i>Negative aspects</i>	4.3.2.3 Networks	Douma and Schreuder, 2008 Peng, 2003	Does it take time/ expense to maintain your network?	IGP11	High transaction costs of maintaining <i>guanxi</i> or network
	4.3.2.3 Networks	Poppo and Zenger, 2002 Child and Moellering, 2003	Could you extend your network, or seek opportunities outside it?	IGP13	Pursuit of new opportunities is constrained by network
	4.3.2.3 Networks	Whyte, 1996 Keister, 2001	Is it hard to compete against older firms with extensive networks?	IGP14	Competitive disadvantage of new entrants' limited networks
	4.3.2.3 Networks	Guthrie, 1998 Luo, 2008	Can you tell me about using <i>guanxi</i> to “pull strings”?	IGP15	Perception of <i>guanxi</i> as harmful or corrupt
Social sanctions	4.3.2.4 Sanctions	Zhou and Poppo, 2008 Peng, 2004	Are there social sanctions? Are they an effective deterrent to opportunists?	ISQ2	Sanctions are an ineffective deterrent to opportunists
	4.3.2.4 Sanctions	Douma and Schreuder, 2008	Are changes in people's reputations communicated? Is this easy, routine?	ISQ6	Changes in traders' reputations are not readily communicated
	4.3.2.4 Sanctions	Keister, 2001	Do you prefer to trade with people who have good reputations? Are there any drawbacks?	ISQ7	Prefers to trade with persons of known reputation
Formal institutions					
Financial	4.3.1.2 Funding	Elkan, 1995	Can you borrow from the bank?	FFR1	Lack of access to formal

Research question and concept	Literature review paragraph number	Related citation	Indicative interview questions	Fuzzy set code	Description of fuzzy set – Set of cases with:
		Peng, 2004 Cleaver, 2007 Bai, Lu and Tao, 2006	How much? If not, what stops you?		borrowing
	4.3.1.2 Funding	Peng, 2004 Hu, 2007	How did you fund your building extensions – family, friends, retained earnings?	FFR5	Lack of access to informal borrowing
	4.3.1.2 Funding	Mair and Marti, 2007	Do you have enough funds to participate, compete, upgrade/ extend facilities?	FFR4	Hindered in market participation or investment by lack of funds
	4.3.1.2 Funding	Atradius, 2008	Do you ever buy on credit? From whom, on what terms?	FFR7	Cannot make purchases on credit terms
	4.3.1.2 Funding	Author	Do you have insurance (health, buildings)? Is the cover adequate?	FFR8	Has inadequate insurance cover
Local government	4.3.1.1 Local government	Zhou and Poppo, 2008 Peng, 2004	Which levels of government affect your firm? Is it helpful? Does it do any harm?	FGS1	Local government has a negative impact on business
	4.3.1.1 Local government	Luo, 1997 Elkan, 1995	Do you get any government support? Financial, allocation of materials?	FGS8	Does not receive financial support from the government
	4.3.1.1 Local government	Rao, 2003	Is the local government efficient?	FGS2	Government bureaucracy is inefficient
	4.3.1.1 Local government	Child and Moellering, 2003	Do you have confidence in local government officials?	FGS3	Lack of confidence in government officials
	4.3.1.1 Local government	Child and Moellering, 2003	Are the regulations easy to understand? Clear, consistent?	FGS5	Regulations are opaque/ not readily understood
	4.3.1.1 Local government	Author's fieldwork, 2006	Do the regulations change often? Is it easy to stay up-to-date with the regulations?	FGS4	Regulations change frequently
	4.3.1.1 Local government	Peng, 2004	Are local government officials fair? If not, does this hinder your business? Can you avoid this?	FGS6	Unfairness by government officials hinders the business
Legal	4.3.1.3 Legal system	Cleaver, 2007	Was it expensive (time/ money) to register the firm? Are there any benefits?	FLT1	Company registration was expensive and time-consuming

Research question and concept	Literature review paragraph number	Related citation	Indicative interview questions	Fuzzy set code	Description of fuzzy set – Set of cases with:
	4.3.1.3 Legal system	Douma and Schreuder, 2008 Zhou and Poppo, 2008 North, 2003	Do you trade with strangers? Is this risky? Does the law protect you?	FLT3	Cannot rely on legal protection in impersonal trade
	4.3.1.3 Legal system	Zhou and Poppo, 2008	Could you take legal action if you were cheated? Is it reliable? Is there an alternative?	FLT4	No legal recourse if cheated, informal response is more likely
	4.3.1.3 Legal system	Zhou and Poppo, 2008	Could you take legal action in a dispute? Is it reliable? Is there an alternative?	FLT5	No legal recourse in disputes, informal response is more likely
	4.3.1.3 Legal system	North, 2003	Does the law help to reduce the risks of uncertainty or opportunism? Is there an alternative?	FLT7	Law does not reduce risk of uncertain environment or opportunism
	4.3.1.3 Legal system	North, 1994b Khanna, 2007	Are you confident of your property rights? Is there a risk of expropriation? Do you think you would receive compensation? Would it be adequate?	FLT8	Property rights are not secure, expropriation is likely
	4.3.1.3 Legal system	North, 1994a Poppo and Zenger, 2002 Zhou and Poppo, 2008	Do you think contracts are enforceable? Would you contract with a stranger or only with someone you already trust?	FLT10	Contracts are not enforceable
	4.3.1.3 Legal system	Rao, 2003 Milgrom and Roberts, 1992	Is your site affected by pollution? Do you lose trade? Are you protected?	FLT11	Not protected from externality of pollution
	4.3.1.3 Legal system	Rao, 2003	Do you have to obey any environmental protection regulations? Is this expensive?	FLT12	Cost of obeying environmental protection regulations
	4.3.1.3 Legal system	Cleaver, 2007	Do these formal institutions protect you from risk? Do you also your informal methods? In which do you have more confidence?	FLT13	Not confident that they can hedge against risk by formal institutions

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