

## The transaction cost economics (TCE) theory of trading favors

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**Abstract** Trading favors is a pervasive business practice, especially in emerging economies. To date, a range of theories has been utilized to explore trading favors, but most extant studies focus especially on negative aspects of favors (e.g., corruption and bribery). We adopt transaction cost economics (TCE) to analyze systematically trading favors as an economizing practice serving efficiency purposes. From the TCE perspective, trading favors is a component of the relational contracting portion of transaction governance, and contributes to economizing on bounded rationality and bounded reliability. We hypothesize that trading favors will be more prevalent in (1) macro-contexts characterized by a vacuum of formal institutions as well as by excessive formal rules; (2) cultural contexts where in-group membership is highly valued; (3) high bounded rationality/low bounded reliability contexts where frequent opportunities exist for indirect reciprocity; and (4) cases whereby no asset-specific investment(s) in innovation need to be made by the supplier of the favor. Enforcement mechanisms such as in-group sanctions, access to formal contracting as a complement to favors, possibility of image scoring and incentive compatibility can function as critical components of the trading favors practice. We suggest a classification of favor trading practices based on their link to formal contracting and rate of recurrence, and describe a range of likely impacts.

**Keywords** Transaction cost economics · Trading favors · Informal organization · Bounded reliability · Bounded rationality · Emerging economies

Trading favors, meaning the informal transfer of goods, services, or opportunities based on expected reciprocation in the future, is a common business practice. Trading favors is found especially in emerging economies, where formal market institutions

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are typically less developed (Myrdal, 1970), and weak contractual rights protection is pervasive. In conceptual terms, trading favors can be described as the utilization of informal modes of exchange within the formal sector (Li, 2007; Mudambi, Navarra, & Delios, 2012). This practice can occur in any part of a value chain and at any organizational level, but also at the macro level and in the public sphere; favors can range from gifts, commissions, and financial inducements, to granting employment or business contracts and exchanging valuable information. The rise of emerging economies, where trading favors is not just a commonly observed business practice, but often also a *necessary* one, has brought this long-lived phenomenon to the forefront of international business research during the past two decades. A number of theoretical frameworks from a range of social science disciplines have been utilized to explore trading favors, including economic rent-seeking theory (Besley & McLaren, 1993; Murphy, Shleifer, & Vishny, 1993), institutional theory (Collier, 2002; Puffer, McCarthy, & Boisot, 2009), property rights theory (Jagannathan, 1986), game theory (Macrae, 1982; von Hippel, 1987; Yamagashi, Mifune, Liu, & Pauling, 2008), the risk-taking paradigm (Lee, Qian, Yu, & Ho, 2005), sociocultural perspectives (Armstrong, 1992; Davis & Ruhe, 2003; Husted, 1999; Treisman, 2000) and transaction cost economics (TCE) (Husted, 1994). Most of these studies have focused on the negative aspects of favors, especially in the context of corruption and bribery, and on the public dimension of the exchange (e.g., when it occurs between corporations/entrepreneurs and governments).

TCE has been largely underutilized as a conceptual lens to study trading favors, in spite of its analytical power (Husted, 1994). First, TCE's economizing orientation enables analysis of trading favors' economizing properties (if any). Second, its focus on comparative institutional analysis facilitates an evaluation of the costs and benefits of trading favors against the costs and benefits of other real world alternatives for governing transactions. Third, TCE recognizes that outcomes at the micro-level can be fundamentally affected by macro-level shift parameters. Macro-level shift parameters do not simply refer to institutional changes over time in one jurisdiction or well-defined geographic area. Macro-level shift parameters refer to all the variables that could reasonably affect the adoption, the specific governance features, and the outcomes of a practice, and that may differ from one jurisdiction or geographic space to the other. One example is the property rights protection regime, which can differ substantially between countries. As a result, TCE can easily accommodate variables that are the main focus of complementary conceptual perspectives, likely needed to explore fully trading favors as a business practice. Such variables include, *inter alia*, government regulation of business, cultural elements, institutional voids, and industry structure, and so on. Fourth, internalization theory, which is essentially the international business extension of TCE (and is for that reason sometimes referred to as transaction cost internalization), embodies a dynamic capabilities view of the firm, thereby providing a robust and integrated conceptual platform from which to analyze multinational activities with all their complexities, including network aspects (Grøgaard & Verbeke, 2012; Rugman, D'Cruz, & Verbeke, 1995; Verbeke & Kano, 2012b).

The above suggests that TCE can provide a valuable conceptual lens to analyze the trading favors phenomenon. A small number of researchers has considered the TCE implications of trading favors (see Fisman & Wang, 2010; Kalla, 2010; Mudambi et al., 2012; von Hippel, 1987), but Husted's (1994) article remains the only published

piece to date to use TCE as an analytical tool for exploring the trading favors phenomenon in a systematic way. Still, Husted's pioneering piece focused rather narrowly on one particular negative aspect associated with some transactions ruled by trading favors, namely corruption. Husted indeed described corruption-related trading favors in TCE terms, with the purpose of designing strategies to safeguard against it! While providing an insightful perspective of corruption, analyzed in TCE terms, Husted's study did not lead to a broad and unified TCE-based framework to analyze trading favors.

We set out to fill this void by analyzing trading favors as an economizing practice serving efficiency purposes in a particular institutional and broader macro-level context, without assuming that negative spill-overs will necessarily occur (in contrast to, e.g., the case of corruption). We assume on the contrary that, subject to a number of conditions being fulfilled, trading favors represents a business practice consistent with farsighted contracting and/or managing the innovation process in its entirety, and can have positive consequences both for the firm and for society at large by enabling transactions that otherwise may not take place (e.g., political connections enabling corporate diversification in China as described in Li, He, Lan, & Yiu, 2012). We adopt TCE as a credible conceptual lens to analyze the economizing properties of trading favors, and formulate a number of unambiguous and testable predictions related to this business practice. In the next two sections, we briefly review TCE and offer some history and context for the trading favors phenomenon. Then, we explore the applicability of TCE to trading favors, conceptualize trading favors in TCE terms, and formulate testable hypotheses. We conclude with theoretical implications and directions for future research.

## Transaction cost economics' foundational concepts

### Main tenets

TCE is widely recognized as a core paradigm in the management and organizational studies literature (David & Han, 2004; Hill, 1990). Rooted in the pioneering work of Coase (1937), TCE in its current form largely owes its existence to Oliver Williamson—the leading figure of TCE, whose contribution to the field was rewarded with the 2009 Nobel Prize in Economics. Coase sought to explain the existence of hierarchies as opposed to markets by analyzing transaction costs involved in effecting exchanges, positing that a hierarchy supersedes the market if the costs of organizing exchanges within a firm are lower than the transaction costs of performing the same exchange in the market. Williamson's version of TCE builds upon Coasean thinking by intersecting the theory's economic foundations with law and organization, and by posing “the problem of economic organization as a problem of contracting” (Williamson, 1985: 20). The transaction, which “occurs when a good or service is transferred across a technologically separable interface” (Williamson, 1985: 1), is TCE's basic unit of analysis; the organization of economic activity is thereby to be understood in transaction cost economizing terms. Economic efficiency is achieved by aligning governance structures with various attributes of transactions in discriminating (“transaction cost economizing”) ways (Riordan & Williamson, 1985).

## Core assumptions

Three core assumptions about the nature of the “*assets*” involved in a transaction and about economic actors’ behavior underlie TCE: asset specificity, bounded rationality, and opportunism (Williamson, 1996). Asset specificity means that particular assets (physical, organizational, or human) involved in a transaction or class of transactions cannot be easily redeployed elsewhere without significant loss of economic value. Differences in degree of asset specificity are largely responsible for observable differences in transaction costs: the more specific the assets, the costlier the transaction, because more safeguards must be introduced in contract content and process to protect the owner of the specific asset against economic loss. Over the long run, greater asset specificity not only increases transaction costs associated with simple, short term market contracting, but also leads to bilateral dependency between exchange partners. This bilateral dependency translates into more complex, longer term contracting schemes, including a transition from market exchange to hierarchical governance (Williamson, 1996).

The effect of asset specificity is closely related to two assumed behavioral characteristics of economic actors involved in transactions. First, bounded rationality refers to economic actors’ behavior that is “*intendedly* rational, but only *limitedly* so” (Simon, 1961: xxiv), meaning that human actors are limited in their capacity to process information, address complexity, and make optimal choices, both because of the natural boundaries of the human mind, and because of the unavoidable incompleteness of available information. In the presence of bounded rationality, all contracts are necessarily incomplete, which creates problems especially when asset specificity is involved.

Second, human agents who populate firms and markets are assumed to have an inherent proclivity toward opportunism. Williamson defined opportunism as “self-interest seeking with guile” (1981: 1545), which manifests itself in “calculated efforts to mislead, distort, disguise, obfuscate or otherwise confuse” (1985: 47). Opportunism has a particularly damaging effect on transaction costs when asset specificity is greater, because aggrieved parties cannot abandon a transaction without incurring high costs from trying to salvage and redeploy the assets committed. Here, opportunism is the ultimate behavioral driver of both market failure and the rise of hierarchy (Williamson, 1993). The normative, short and medium term implications of the combined three assumptions are thus that governance mechanisms (including labor contracts and human resources management systems) should be designed so as to economize on economic actors’ bounded rationality and opportunism.

## Extending behavioral assumptions of TCE: Bounded reliability

It should be noted that the behavioral assumption of opportunism has been the subject of significant controversy in the organizational sciences field (Connor & Prahalad, 1991; Ghoshal, 2005; Ghoshal & Moran, 1996; Hodgson, 2004; Tsang, 2006). It has been criticized for its narrow conceptual focus, an inadequate portrayal of reality, and the lack of sufficient empirical support. In the absence of convincing evidence that opportunism is indeed a universal driver of economic actors’ behavior and consequent governance choices as suggested by Williamson (1993), there is a need for an

alternative explanation of humans' non-fulfilment of commitments that drives TCE-based predictions on the selection and retention of governance mechanisms. Verbeke and Greidanus (2009) filled this void by proposing the envelope concept of *bounded reliability* as an alternative explanation of failed human commitments. Bounded reliability supplants the assumption of opportunism by including the many situations in which parties' failure to deliver on commitments is *not necessarily* explained by a strong form of self-interest, but is caused by a variety of factors *including but not limited to* intentional deceit, such as benevolent preference reversal associated with reprioritization and with scaling back on overcommitment<sup>1</sup> (Verbeke & Greidanus, 2009). Bounded reliability is distinct from bounded rationality; while bounded rationality reflects the scarcity of mind, bounded reliability refers to the scarcity of effort to make good on an open-ended promises. To summarize the interrelationships among bounded reliability, bounded rationality, and opportunism: Human actors engaged in economic transactions may fail to make good on open-ended commitments for a variety of reasons that cannot be reduced to a bounded rationality problem, but may at the same time be unrelated to self-interest seeking with guile (i.e., intentional deceit).

In the remainder of this paper, we will use the extended behavioral assumptions of TCE, substituting the incomplete and ideology-laden assumption of opportunism with the broader, non-ideological assumption of bounded reliability. We assume that there is a systemic tendency for transactions to suffer from benevolent preference reversal, ranging from breaking a specific and explicit promise at the project level, to not respecting a broader and more implicit promise, such as working towards shareholder utility maximization. Optimal governance choices (e.g., the choice of markets vs. hierarchies or hybrid forms of governance, as well as the choice of more narrow governance mechanisms with their distinct economizing properties) are thus driven by the asset specificity of transactions, as well as by the bounded rationality and bounded reliability of the economic actors involved in these transactions.

Given the above, our comparative analysis of trading favors as part of a governance mechanism, to be compared with other ones, will consider the specificity of assets involved in trading favors, and trading favors' economizing properties in terms of safeguarding against bounded rationality and bounded reliability problems.

## Trading favors: Origins, foundations, and manifestation

### Anthropological, economic, and cultural foundations

According to Nobel laureate Vernon Smith, "all humans, of all cultures, engage in the trading of favours" (Smith, 1998: 4). The practice of trading favors can be

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<sup>1</sup> Good faith reprioritization captures instances whereby economic actors make *ex ante* commitments in good faith (with benevolent intent), but the importance of those commitments diminishes over time (preferences are reordered). Time discounting bias (placing a lower value on future events than more proximate events) can also cause economic actors to reprioritize, and postpone efforts to make good on commitments to the point that such commitments can no longer be fulfilled. Scaling back on overcommitment results from the tendency of managers to make excessive commitments *ex ante*, that then need to be scaled back *ex post*.

described as trade in goods, services, or opportunities, whether monetary or non-monetary (Kalla, 2010). The practice is rooted in humans' universal propensity "to truck, barter, and exchange" (Smith, 1998: 4), which dates back to at least two million years (i.e., a time period when our hominid ancestors lived as hunter-gatherers in extended families and tribes) (Klein, 1989; Semaw et al., 1997). Trade in the conventional economic sense has likely grown directly out of social exchange among kin and out of gift exchange common in hunter-gatherer societies; see Freuchen (1961) for an account of the Greenland Eskimos' gift exchange. The transformation of social exchange into formal trading relationships allowed the gains from an exchange to be extended beyond the reach of one's family or tribe and ultimately became the root cause for the allocation of property rights. When our ancestors broke out of local exchange patterns and started to engage in more long-distance exchange (Smith, 2005), impersonal formal markets gradually replaced the informal social exchange of goods and various types of favors. In Europe, for example, the dissolution of feudal bonds and greater labor mobility led to the expansion of trading relationships—and the consequent weakening of local networks—at the beginning of the 16th century (Puffer et al., 2009), marking what Sir Henry Sumner Maine famously termed the movement "from status to contract" (Maine, 1959: 182).

This is not to say that social exchange disintegrated—only that it was now mainly applied in the domain of a small grouping of one's kin, whereas the world of markets had become separate and distinct. Frederick Hayek's famous quote summarizes the conflict between intimate and formalized relationships inherent in the transition to markets: "*Part of our present difficulty is that we must constantly adjust our lives, our thoughts and our emotions, in order to live simultaneously within different kinds of orders according to different rules. If we were to apply the unmodified, uncurbed rules (of caring intervention to do visible "good") of the micro-cosmos [personal exchange] ... to the extended order of the macro-cosmos [impersonal exchange], as our instincts and sentimental yearnings often make us wish to do, we would destroy it. Yet if we were always to apply the rules of the extended order to our more intimate groupings, we would crush them. So we must learn to live in two sorts of world at once*" (Hayek, 1988: 18).

Development of formal economic and societal institutions served to separate further the two worlds of impersonal and personal exchange. Obviously, greater development of formal market institutions led to greater separation. Consequently, in emerging markets, where the growth of formal institutions was slower (Puffer et al., 2009), and the evolution from informal to formal institutions commenced later (Peng, 2003), impersonal and personal exchange remained intertwined to a greater extent, reflecting the current "informal embeddedness or interconnectedness with dominant institutions" (Peng, Lee, & Wang, 2005: 623). Lesser population mobility in developing countries (due to lesser wealth) serves to tie individuals to local communities, further strengthening the importance of local networks. Yet, historic and present differences in socioeconomic characteristics of different societies are not *solely* responsible for these societies' different levels of engagement in favor trading.

Let us reiterate that formal trade and informal exchange share the same foundation: humans' universal capacity for reciprocity (Smith, 1998). While reciprocity is



believed to have universal functionality, its specific norms guiding exchange are a product of culture, which makes forms of reciprocity “endlessly variable” (Smith, 1998: 4). The variability of trading favors practices across societies exists because “actors do not respond directly to situations, but respond to them through mediating orientations” (Mudambi & Navarra, 2003: 39), rooted in the underlying culture(s) within which individual actions are performed. Informal favors are thus significantly affected by cultural factors (Lee et al., 2005): For instance, relational cultures that emphasize strong interpersonal involvement will be more prone to widespread adoption of the trading favors practice (and will exhibit a higher tolerance to its negative spill-overs) (Mudambi et al., 2012). Such cultures are known for the pervasive intermingling of business practices with tight interpersonal connections, as exemplified in such phenomena as *blat* in Russia, *protetzia*<sup>2</sup> in Israel, *guanxi* in China, *wa* in Japan, *inhwa* in Korea, *cuna* in Chile, *palanca* in Mexico, and so on. To illustrate the practice of trading favors, we will take a closer look at two of these practices: *blat* and *guanxi*.

#### Manifestations of trading favors in Russia and China: *Blat* and *guanxi*

*Blat* *Blat* is a hard-to-translate Russian word referring to “an exchange of ‘favours of access’ in conditions of shortages and a state system of privileges” (Ledeneva, 1998: 37). *Blat* is often equated to corruption in the Western literature, yet it is very distinct from illegal practices and open abuses (e.g., bribery) associated with corruption. Rather, it is an openly condoned form of networking that facilitates business exchanges—“a favour one renders to someone else without any immediate personal profit or direct violation of law” (Shalin, 1999: 588).

The noun “*blat*” stems from the 19th century adjective “*blatnoi*,” denoting a person or object related to criminal activity, though the modern version of the word carries no criminal connotations, nor moral opprobrium (Shalin, 1999). In its present meaning, the term was established during the years of socialism, when consumer goods were in short supply, and special privileges were required to gain access to desirable goods or services. *Blat* did not imply payment for access, as goods were more valuable than money in the absence of a free market system; gradually, *blat* developed into an “alternative procurement system” (Shalin, 1999: 559) routinely activated to gain access to better housing, rare consumer goods, theater tickets, jobs, hotel reservations, sought-after doctor appointments, an injection of an anaesthetic in a dental office, and so forth. The idea is that a recipient utilizes his or her network of friends and acquaintances to find an individual with ties to the desired goods; this individual (the donor) does not expect payment beyond perhaps a token gift of appreciation, but may require a reciprocation of the favor at some point in the future. Failure to reciprocate may result in informal sanctions within the network, such as disapproval, withdrawal of privileges, exclusion and, in extreme cases, ostracism.

<sup>2</sup> Linguistically, *protetzia* is in fact a borrowing from the Russian “протекция,” literally meaning “protection.” Both the word and the practice were likely influenced by extensive Russian emigration to Israel.

With the collapse of the socialist economy in Russia and the onset of the free market, *blat* has lost its importance as an alternative procurement enterprise; some believe that the institution of *blat* is beginning to disintegrate, taking with it the fabled Russian friendship which is giving way to commercial arm's-length relationships (Ledeneva, 1998; Shalin, 1999). Yet, in the current situation characterized by undeveloped legal and financial infrastructure, excessive administrative discretion and corruption in government offices, restrictive taxation, high interest rates, inflation and frail property rights (Puffer et al., 2009), *blat* continues to act "as an oil in the wheels of Russian business" (Barnes, Crook, Koybaeva, & Stafford, 1997: 540) and to facilitate many business transactions. Additionally, *blat* is deeply embedded in the Russian culture, rooted in traditional Russian values of friendship and mutual help. With the transition to the market economy, the role of *blat* as a redistribution system may indeed diminish, yet it is quite likely to linger in the future, remaining an openly condoned form of business networking. It is difficult to predict unambiguously the role that *blat* will continue to play in modern day Russia; future empirical research should determine whether the practice's importance has continued to diminish over time.

*Guanxi* *Guanxi* has been defined as pre-existing relationships of classmates, people from the same native place, relatives, colleagues, people who served in the same combat unit, and so forth (Yang, 1988), and "involves a hierarchically structured network of relationships embedded with mutual obligations through a self-conscious manipulation of "face", "renqing" and related symbols" (Wong & Tam, 2000: 58). *Face* refers to one's reputation within the network; *renqing* refers to set of social norms inherent in belonging to a network, such as dynamic reciprocity, long-term orientation and, often, unequal exchange (Luo, 2000). Unlike *blat*, which is an exchange among equals, *guanxi* is a hierarchical institution whereby status matters. *Guanxi* therefore has a broader meaning than *blat*: While *guanxi* can and does occasionally involve mutual "back-scratching," which is the essence of *blat*, it includes belonging to a network of trusted individuals (Puffer et al., 2009). *Guanxi*'s relationship to trading favors is that it can facilitate the latter if necessary by enforcing interpersonal obligations within the network.

*Guanxi* is deeply rooted in the Chinese culture with its strict Confucian codes of ethics, filial piety, and shame inculcation (Wong & Tam, 2000), as well as the high value attached to family ties. Chinese socialist history has complemented the tradition of *guanxi* (Wall, 1990): In an environment of controlled pricing and limited access to goods, the utilization of private connections became a way to give and receive important favors.

Like *blat*, *guanxi* is not synonymous with corruption, though it is easy to imagine how "excessive *guanxi*" (Wall, 1990: 23) could take the form of corruption, especially under current conditions of underdeveloped market and financial institutions and weak legal enforceability. Today, the Chinese population's increasing wealth and the general alleviation of scarcity of goods and services is lowering the need for special favors and thereby the scope of *guanxi* (Puffer et al., 2009). Still, being a deeply embedded practice, both culturally and socially, *guanxi* is likely to remain a prominent informal institution in the Chinese society for decades to come.



## TCE-based theory of trading favors

### Working definition and key questions

The starting point of our analysis is to determine what trading favors actually *is* from the TCE viewpoint. It is not a distinct, generic governance structure, and therefore not the equivalent of markets, firms, or hybrids. Nor is it a generic coordination mechanism such as the price mechanism or hierarchy (i.e., decision making by fiat), utilized by parties to support the governance of transactions.

Williamson suggests that a transaction “occurs when a good or service is transferred across a technologically separate interface” (1985: 1). All transactions are subject to governance through some form of contracting. TCE subscribes to a conception of contract as framework as opposed to contract as legal rules (Williamson, 1996). The notion was developed by Karl Llewellyn, who argued that a contract between two parties “*almost never accurately indicates real working relations, but... affords a rough indication around which such relations vary, an occasional guide in cases of doubt, and a norm of ultimate appeal when the relations cease in fact to work*” (1931: 737). All formal contracts are therefore necessarily incomplete. A complete contracting framework governing any transaction can be seen as consisting of two components: (1) formal contracting, referring to codified information (e.g., contract documents); and (2) relational contracting, referring to informal aspects of contracting as measured by the collaborative attitude of parties, sharing of goals, reliance on unwritten promises, and so on. The specific content of the second, relational component of contracting is largely a reflection of socially derived norms and social ties between the contracting parties. The main contractual action resides in the private ordering; a personal or group-driven relationship between parties enables easier *ex post* governance should any problems arise.

The interesting feature of trading favors is that it implies the presence of at least two transactions, whether within a market structure, a firm, or a hybrid. A “favor” also implies expected or intended reciprocation in a sequence of exchanges, which are based on socially derived norms and social ties. This reciprocation may or may not be delayed, and does not necessarily reflect a direct response to the original favor. Given the above, we offer the following definition of trading favors:

*Trading favors is a component of the relational contracting portion of transaction governance. It involves the norm of reciprocity and includes enforcement mechanisms. It occurs when at least two transactions take place, with the roles of favor supplier and receiver being reversed in sequential transactions. The reciprocity can be delayed and be indirect. It contributes to economizing on bounded rationality and bounded reliability involved in these transactions.*<sup>3</sup>

If trading favors is supposed to function as a relational contracting component and to perform an economizing role, two questions arise:

<sup>3</sup> Our viewpoint is different from Husted’s (1994), who looked solely at corruption (associated with an extreme type of trading favors with substantial negative spill-overs) as a distinct class of transactions, involving a private exchange between two parties, and associated with abuse of a public or collective responsibility.

1. When is trading favors efficient (at the macro-, group- and micro-levels) and when is it not? In other words, if trading favors did not exist as part of relational contracting, how would the relevant set of transactions be conducted?
2. What enforcement mechanisms can be used to guarantee the (possibly delayed) reciprocal portion of the exchange?

When is trading favors efficient?

In general terms, trading favors can be considered efficient if it is superior to other contracting alternatives at economizing on bounded rationality and bounded reliability in the context of governing a particular transaction or set of transactions. As trading favors is observed at the macro-, group-, and micro-levels, we explore specific conditions for its efficiency at each of these three levels.

*Macro-level* There is a consensus in the literature on trading favors that this practice is most frequently observed in developing and transition economies. Institutional theory, which has been adopted as one of the leading conceptual frameworks for studying emerging economies (Hoskisson, Eden, Lau, & Wright, 2000; Meyer & Peng, 2004; Peng, Lu, Shenkar, & Wang, 2001), explains the common occurrence of the practice by the fact that informal institutions—including trading favors as a relational contracting component—are used to fill voids in the realm of formal institutions such as private property rights protection, judicial and financial systems, contract-enforcing government institutions as well as local intermediary firms supplying services through formal contracts. Resource-based view (RBV) researchers concur that informal transactions will be more important in the absence of well-developed institutional infrastructure, due to the fact that efficient institutions facilitate the securing of strategic resources in the open market and thus reduce the need for favors as a mechanism to access resources (Li et al., 2012; Wan, 2005). TCE offers a parallel explanation, suggesting that trading favors will be the relational contracting component of choice in contracting situations where bounded rationality and bounded reliability challenges are strong, and formal rules and institutions represent an insufficient governance response. For example, institutional voids in capital, labor, and product markets create bounded rationality challenges for firms trying to access potential partner companies, employees, and customers. The lack of enforceable accountability rules (e.g., in the realm of transparency and disclosure) exacerbates information asymmetries between parties (Chen, Ding, & Kim, 2010), thereby further contributing to bounded rationality challenges. Absence of transparency and disclosure also hinders proper evaluation of business partners' efforts to fulfil commitments, thus creating severe bounded reliability problems (Verbeke, 2009). The absence of efficient local intermediary firms (e.g., specialized market research firms, end-to-end logistics providers, human resources management firms, etc.) creates bounded rationality and reliability challenges by hindering access to requisite market information, distribution services, and an optimal employee reservoir (Khanna & Palepu, 1997). Bounded reliability challenges are further compounded by weaknesses in legal enforceability mechanisms often found in emerging economies. In such situations, trading favors can serve as a “bond” to secure transactions, facilitating both information exchange and enforceability. Thus, TCE provides substantive content to institutional theory's

contention that trading favors will prevail in contexts characterized by institutional voids. This line of thinking is to some extent supported by empirical evidence: Zhou and Peng (2012) demonstrated on the basis of a large-cross-country sample of 2,686 firms that informal favors are utilized to a higher level when embedded in under-developed institutions.<sup>4</sup> Li et al. (2012) convincingly showed, building upon a longitudinal sample of 1,280 Chinese public firms, that favors are more instrumental to firm growth when market mechanisms and intermediate institutions are less developed.

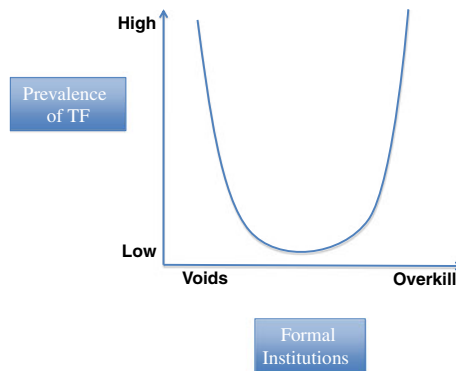
An additional analytical dimension brought by TCE is that excessive formal rules and other institutions may also inhibit efficient transacting. For example, Mudambi et al. (2012) demonstrated that higher levels of government regulation in an economy can lead to higher levels of corruption (a negative spill-over of favors trading). A regulatory environment where firms face excessive legal obstacles to enter an industry or to operate a business, or one that imposes excessive antitrust regulations on outsiders, can create bounded reliability challenges by favoring industry incumbents over new entrants, prompting new entrants to seek favors trading in order to overcome policy-induced barriers to trade and investment. In addition, excessive formal rules and other institutions can cause bounded rationality challenges through information overload, thereby also inviting favors trading as a safeguard for firms to ease their way through a non-transparent and dysfunctional web of obligations imposed by society. In contrast, well-established market institutions characterized by transparent and smoothly implementable rules and regulations, will reduce incentives for trading favors (Mudambi et al., 2012) by alleviating potential bounded rationality and bounded reliability problems. We hypothesize that both an institutional vacuum and institutional overkill create bounded rationality and bounded reliability challenges that can be usefully alleviated by trading favors (Fig. 1).

**Hypothesis 1** U-curve hypothesis (macro-level): Trading favors will be more prevalent in contexts characterized by (a) a vacuum of transaction-supporting formal rules and institutions (including their enforcement features), and/or (b) excessive, transaction-burdening formal rules and institutions that hinder efficient transacting.<sup>5</sup>

*Group-level* A group is a collection of individuals who share particular features, which may include social norms, social interactions, common experiences, and so on. An in-group exchange of favors (often to the detriment of those outside of the group) appears to be a widely practiced phenomenon in both emerging and developed

<sup>4</sup> Zhou and Peng's study focused specifically (and more narrowly) on bribery. To the extent that bribery can be interpreted as a specific (albeit potentially damaging) form of favors, their study does provide partial evidence that favors are more prevalent in underdeveloped institutional contexts.

<sup>5</sup> It should be noted that in real world situations a complete vacuum of formal rules is unlikely, as even newly emerging economies usually possess burdensome regulations in some policy areas. However, these economies simultaneously suffer from the lack of efficient, local intermediary firms. The institutional voids referred to in Hypothesis 1 pertain to the vacuum of helpful/business-friendly regulations and institutions that facilitate transactions and ensure their transparency, the information disclosure associated with them, and their legality.



**Fig. 1** Trading favors (TF) U-curve hypothesis for the macro-level

economies, with groups ranging from ethnic minorities and castes to university alumni networks (Bramoulle & Goyal, 2009; Chua, 2003; Kramarz & Thesmar, 2006; Pande, 2003) and informal trading networks among individuals with common professional interests (von Hippel, 1987).

Research shows that operation of the group heuristic is stronger in some cultures than in other ones (Yamagashi et al., 2008). In cultures and regions that downplay belonging to a network, firms will tend to rely more on arm's-length relationships and formal contracting (Cai, Jun, & Yang, 2010). In contrast, in cultural contexts where in-group membership is highly valued, reputation and social bonds can act as a system of private law, enabling widespread informal exchange (Bernstein, 1990). Favor-trading transactions thus become socially embedded in close-knitted communities (Granovetter, 1985). The "close-knittedness" of any group is likely to facilitate frequent and recurrent transactions, creating situations of bilateral dependency and consequent contracting hazards (Williamson, 1996). Trading favors comes in as an economizing mechanism against these hazards in recurring transactions.

Finally, groups are characterized by sharing a perceived distance vis-à-vis out-group members, which is evident even in groups sharing the seemingly most trivial, common characteristic (Yamagashi et al., 2008). Williamson (1996) described a community of Jewish diamond traders, where in-group to out-group distance is a partial result of long-term discrimination by outsiders, and entry is restrictive. The size of the in-group vis-à-vis the overall reference population is likely to affect the in-group to out-group distance. Olson's (1965) theory of groups suggests that the size of a group is inversely related to individual information levels. Membership of smaller groups is therefore more valuable in order to alleviate bounded rationality caused by information asymmetries (Mudambi, Navarra, & Nocosia, 1996). The end result is a more "exclusive" group with a larger, common distance to out-group members. Such distance can be reinforced through a system of extra-legal rules (e.g., rules emanating from religion or geography, or community-based ones) that govern the group but do not apply to out-group members. In "exclusive" groups, trading favors will prevail as a mechanism that can economize on bounded reliability more cost-effectively than alternative (i.e., legal or formal) systems of rules:

**Hypothesis 2** Group distance hypothesis: Trading favors will be more prevalent in cultural contexts where in-group membership is highly valued. This prevalence will be stronger in the presence of recurrent transactions and a higher perceived distance vis-à-vis out-group members.

*Micro-level (private transactions)* A private transaction is a transaction that occurs between two actors with no (or limited) *ex ante* information dissemination to third parties. Williamson (1996) describes the breakdown of a farmer's hay baler with the prospect that the crop would be ruined by rain. The farmer is saved by a neighbor's offer to help bale the hay without charge except to reimburse for the gasoline. Williamson views the situation as an example of informal organization: informal, reciprocal favors represent a component of this type of governance. Direct reciprocation is not required, but a similar act of (emergency) assistance is expected in the future should another member of the small community need it, thus creating a circle of recurrent, calculative support (making this situation somewhat analogous to the one described above for the group level). This type of *perpetual good news*, however, is only possible if the relevant community is able to apply sanctions effectively for failure to reciprocate, with sanctions ranging from moral suasion to ostracism. In the presence of such safeguards and assuming a sufficiently small community ("where everybody knows your name"), bounded reliability problems are unlikely to occur. Here, spontaneous cooperation between two parties is fostered by the presence of a high reliability environment. Bounded rationality, on the other hand, may be high, with tacit information carried in the mind of each transacting party, and with a general lack of knowledge as to when a reciprocal transaction might occur, and what its substance would be. However, it is precisely because the timing, scope, and scale of the private exchange of favors, and even the identity of the contracting parties may be unknown *ex ante*, that trading favors can contribute to economizing as compared to the use of formal contracts required in a situation of "less spontaneous cooperation" (Williamson, 1996: 263). As a final point on micro-level exchange, the cost of each favor as perceived by the supplier must systematically be lower than the benefits perceived by the recipient; this situation is likely to occur when the demand for a favor results from a "crisis event" in the life of the favor recipient, but ultimately requires only an incremental effort from the supplier to solve this crisis.

**Hypothesis 3** Perpetual good news hypothesis for private transactions: Trading favors will be more prevalent in contexts (1) with severe bounded rationality problems, but only minor bounded reliability challenges; (2) where frequent opportunities exist for indirect reciprocity; and (3) where  $c < b$ , with  $c$  as the cost of each favor perceived by the supplier, and  $b$  as the benefit of each favor as perceived by the recipient.

Let us clarify that the above severe bounded rationality problems refer to high levels of uncertainty about future transactions (in terms of their actual occurrence, timing, frequency, content, magnitude, required investments, etc.). In contrast, absence of severe bounded reliability problems is usually observed when formal and informal sanctions are readily available to enforce transactions, and/or when the loyalty of actors involved in transactions, as a driver to make good on their

commitments, is very high. A well-functioning family is an example of a high bounded rationality/low bounded reliability context: the organization is small, the future is unforeseeable, and a spontaneous exchange of favors is expected among members (excluding perhaps dysfunctional families). In the business context, this extends to family firms that are characterized by family-based human asset specificity (Verbeke & Kano 2010, 2012a), meaning that such companies may suffer from a shortage in terms of both the quantity and quality of required human resources. At the same time, family-based human asset specificity implies unique access to a stable and loyal human resources base with limited adverse selection (Pollak, 1985), meaning low bounded reliability within the firm and frequent opportunities for both direct and indirect reciprocity. Our prediction, therefore, is that trading favors will be more prevalent within family firms than in, for example, “Chandlerian” hierarchies.

Similarly, R&D organizations in turbulent environments, where uncertainty is high and technological systems are complex, will find it challenging and costly to engage in farsighted formal contracting for completely unproven, emerging technologies. In such environments, trading favors, especially when the exchange of pieces of technological know-how inside the firm is involved (and even outside of it, in the presence of co-located companies operating in the same pre-competitive cluster), can facilitate cost-reducing innovation (von Hippel, 1987).

*All levels* From a transaction cost-economizing perspective, supplier investment in the favor should not exceed the perceived benefit to the recipient at any level of favors trading, in order for the transactions to occur. Assuming that asset specificity—and especially vulnerable, state-of-the-art innovations embedded in specific assets—drives costs associated with transactions, greater asset specificity over time will lead to more bilateral dependency between contracting parties. While trading favors may then still operate as a relational component of contracting, it may no longer be satisfactory as a primary mechanism to govern complex classes of bilaterally dependent transactions, and will either become a complement to formal contracting, or will be completely supplanted by longer term and more complex forms of contracting. This leads to:

**Hypothesis 4** Absence of supplier asset specificity hypothesis (all transaction levels): Trading favors will be more prevalent in cases whereby no asset-specific investments/investments in innovation need to be made by the supplier of the favor. This also holds for the supply of the reciprocal favor.

What enforcement mechanisms facilitate trading favors?

In the absence of formal contracting, and in the presence of informal exchange governing how favors are extended and honored, enforcement mechanisms represent a critical part of the practice in order to guarantee the reciprocal transaction. These enforcement mechanisms can take several forms:

- 1) *In-group sanctions* can be utilized in tight-knit communities to enforce reciprocity. In-group punishments can be facilitated by close social ties, and can range



- from mild reprimand to ostracism (consider *blat* and *guanxi* networks discussed above). Easy aggregation and dissemination of information in close groups enables in-group sanctions (e.g., diamond traders practice displaying pictures of non-trustworthy individuals in trading rooms).
- 2) *Access to formal contracting as a complement* to trading favors may be necessary in cases where highly asset-specific investments are unavoidable, in order to prevent an obsolescent bargain. Obviously, this is an option only in an environment with fully functioning institutional checks and balances (and thus may not be available to transacting parties in emerging economies, as discussed above).
  - 3) *Possibility of image scoring* refers to situations whereby granting a favor may raise an individual's/organization's image or status as perceived by others. The supplier of the favor therefore benefits from indirect reciprocity, which compensates for potential loss of value should the favor not be reciprocated by the original recipient. Invoking this enforcement mechanism, however, requires an organizational capacity to assess and readjust images when required.
  - 4) In cases of indirect reciprocity (as in the above situation of image scoring), each party involved in the practice becomes a residual claimant (Alchian & Demsetz, 1972) of benefits arising from the system of favors. In this case, *incentive compatibility* among all actors involved must be established for the indirect reciprocity incentive to be effective in safeguarding the transactions.

### Types and impacts of trading favors

*Classification of trading favors practices* It follows from the above discussion that the practice of trading favors can come either as a complement to formal contracting (as is often the case at the macro-level, especially in developed economies where formal contracting is accessible and enforceable), or as a complete substitute for formal contracting (in private transactions and in informal groups/networks). In terms of frequency, trading favors ranges from unique, two-way reciprocity between two transacting parties to recurrent, multiple-way reciprocity within a network of actors. Figure 2 summarizes a typology of trading favors.

Based on the above classification, we can distinguish among four generic types of trading favors, as identified in Fig. 2. In the first quadrant are unique two-way trading favors practices that complement rather than replace formal contracting, for example, large scale one-time infrastructure projects that are impossible to implement without a formal contract but are necessarily complemented by an informal exchange of favors (e.g., building a pipeline in Russia requires a formal contract with government, as well as deployment of favors in order to gain land access and building permits). In the second quadrant are unique two-way favors that substitute for formal contracting, perhaps best exemplified by Don Corleone's famous quote in *The Godfather*: "Some day, and that day may never come, I'll call upon you to do a service for me. But until that day—accept this justice as a gift on my daughter's wedding day." This type of trading favors need not have mafia connotations; the literature and cinematography

		SCOPE	
		<i>Unique 2-way reciprocity</i>	<i>Recurrent multiple-way reciprocity</i>
LINK WITH FORMAL CONTRACTING	<i>Complements</i>	Q1	Q3
	<i>Substitutes</i>	Q2	Q4

**Fig. 2** A classification of trading favors types

are teeming with examples of great life-saving and life-changing stories that fall within this category of transactions. In the third quadrant are recurrent multi-way favors that complement formal contracting, such as favor trading within formal business networks (e.g., know-how trading in professional associations, trading favors among Jewish diamond dealers); Williamson's hay baler example also belongs in this quadrant, assuming that all farmers engage in some formal joint purchasing of inputs, joint marketing and distribution, and so on. The fourth quadrant is occupied by recurrent, multi-way favors with no intrinsic link to formal contracting—examples include *blat* and *guanxi*, as well as exchanges of favors within any informal network (e.g., *informal* know-how sharing among engineers not belonging to a formal association) (von Hippel, 1987).

*Impact of trading favors* The potential negative impact of trading favors (related to corruption and unethical business practices) has been well documented in the literature (see Chan & Unger, 1982; Chen et al., 2010; Cockcroft, 1996; Groseclose, 1996; Husted, 1994; Jensen, Li, & Rahman, 2010; Lee et al., 2005; Mudambi et al., 2012; Volkema, 1999; among others). Its positive impacts, in terms of enabling transactions and economizing on bounded rationality and bounded reliability has garnered less attention to date. We take a separate look at the micro- and macro-level impacts of favors trading. At the micro-level, we distinguish between trading favors practices that serve an economizing versus an exclusion purpose. At the macro-level, we look at the societal impacts of micro-level behavior, whereby we distinguish between the impacts filling institutional voids and those serving entrenchment, as summarized in Fig. 3. Government policies and mainstream societal practices can obviously reinforce or discourage prevailing micro-level approaches to trading favors and their impacts.

In the *first quadrant*, micro-economizing practices reflect efficiency-oriented behavior that unfortunately leads to negative societal spill-overs, for example when dedicating a scarce resource to a particular favor recipient *de facto* withdraws that resource from others. Unintended discrimination of outsiders by practicing in-group favoritism also falls within the first quadrant.

The *second quadrant*, which can be viewed as “malevolent,” refers to the combination of micro-exclusion and macro-entrenchment outcomes. Think, for example, of illegal favors trading between banks and financial analysts on Wall Street that is insufficiently monitored and punished, as a result of archaic legislation and under-resourced enforcement. Pyramidal control structures characteristic of many countries outside the West (e.g., China, India, and other emerging economies), whereby a few

		MACRO-LEVEL IMPACTS	
		<i>Entrenchment tool</i>	<i>Institutional void filler</i>
MICRO-LEVEL IMPACTS	<i>Economizing</i>	Q1	Q3
	<i>Exclusion</i>	Q2	Q4

**Fig. 3** Four storylines on trading favors' impacts

wealthy families control large corporations without making a commensurate equity investment, also generate quadrant-two-type impacts: these ownership structures reflect corporate governance problems (i.e., resource misallocation) at the micro level, while affecting macroeconomic outcomes in the form of rates of innovation, economy-wide resource allocation, and economic growth (Morck, Wolfenzon, & Yeung, 2005). Profit tunneling in Indian business groups is yet another example: here, owners of business groups (single shareholders who completely control several independently traded firms but have significant cash flow rights in only a few of them) expropriate minority shareholders by tunneling resources from firms where they have low cash flow rights to firms where they have high cash flow rights. This practice can have disastrous societal consequences by hindering equity market growth and overall financial development, clouding accounting and essentially reducing the transparency of the entire economy (Bertrand, Mehta, & Mullainathan, 2002).

Favors trading practices that fall into the third—micro-economizing/macro-void-filling—quadrant of Fig. 3 tell a conventional TCE story. For example, trading favors can be used at the micro-level to increase efficiency of transactions in situations where requisite macro-level, efficiency-enhancing (formal) institutions are absent. The cumulative effect of micro-level trading favors practices may then *de facto* fill an institutional void. Indian business groups (collections of publicly traded firms in a wide variety of industries, with a significant presence of common ownership and control, also prevalent in other emerging countries), replicate the functions of institutions missing in emerging markets.<sup>6</sup> These services that in advanced economies are delivered by a variety of intermediary institutions (e.g., information provision in product, labor and capital markets, as well as some forms of contract and property rights enforcement, etc.) are costly for individual firms to produce themselves. However, large diversified business groups fill the void by investing in internal structures and processes to perform the intermediation function. In the best case scenario, the payoff comes in terms of higher performance of diversified conglomerates at the micro-level, and an economic boost at the macro-level (Khanna & Palepu, 2000). Social welfare may also be enhanced by business group–government liaisons should that relationship support taxation and fiscal policy (Khanna & Yafeh, 2007).

Finally, the fourth quadrant of Fig. 3 pertains to micro-exclusion practices that have a void-filling impact at the macro-level. This storyline is characteristic of non-

<sup>6</sup> Here, we assume that business groups do not engage in questionable practices such as profit tunneling discussed in a previous example, and we use business group governance only as a generic illustration of how institutional voids can be filled.

democratic societies, where private interests are sacrificed for the so-called greater good, typically driven by intermingling of governments and firms through high-level network connections (e.g., imposing a 95 % tax on oil revenues greater than \$100 per barrel on foreign oil and gas multinationals in Venezuela, which creates an unfair advantage for the dominant state oil company). In such cases, substantial favors trading between the ruling government and the micro-level beneficiaries of government favors occurs in parallel with discriminatory measures against other micro-level actors. This is a complex issue with mixed evidence as regards outcomes. Khanna and Yafeh tapped into the grey area with an investigation into whether business groups in emerging markets are “paragons or parasites” (2007: 331). They found that business groups, while serving to fill institutional voids, can engage in rent-seeking through exercising power over incumbent businesses, thereby negatively affecting competition and industry structures.

Having thus considered all potential combinations of trading favors’ impacts, we can conclude that trading favors practices that serve efficiency purposes at the micro-level without negative spill-overs at the macro-level (quadrant 3)—that is, purely economizing trading favors practices—are likely to be sustainable in the long run. Entrenchment and exclusion practices, in contrast, lead to costs associated with negative spill-overs, such as corruption costs, welfare losses from monopolies and rent-seeking behavior, and so on. From a purely transaction cost-economizing perspective, these costs will *in the long run* lead to changes in the macro-level shift parameters to eliminate this type of inefficiency and reduction of societal welfare, leaving room only for efficiency-oriented favors trading. Unfortunately, a range of considerations beyond economics—psychological, sociological, cultural, etc.—may interfere with the realism of this prediction. In other words, we would like to conclude with the prediction that negative spill-overs of favors trading are likely to be eliminated in the long run and that only economizing expressions of the practice will survive; however, at this point, it may be more reasonable simply to echo Lee et al.’s (2005) view that such spill-overs do negatively affect the long-term effectiveness and efficiency of how business is conducted world wide, and, eventually, the welfare of the global economy.

## Conclusion

Previously overlooked as an analytical tool to study trading favors, TCE provides a credible conceptual lens for evaluating trading favors’ economizing features as compared to alternative, real world governance mechanisms to manage transactions. In this conceptual study, we have developed a TCE-based theory of trading favors. We have defined trading favors as a component of the relational contracting portion of how transactions are governed. We have identified the characteristics of transactions that would render trading favors efficient, and have formulated testable hypotheses to investigate trading favors’ efficiency features at various levels (micro, group, macro, and multiple levels). We have described enforcement mechanisms necessary for the effective utilization of trading favors, and have developed a classification of different forms of this practice in terms of the conditions for their

occurrence and their micro- and macro-impacts. We have concluded that trading favors, as an economizing practice, is sustainable over the long run when serving efficiency purposes at both the micro- and macro-levels.

By virtue of its parsimony and predictive capacity, TCE provides a road map to reflect on the practice of trading favors. It enables an investigation of various complex contexts in which trading favors occurs, and allows for a realistic analysis of the phenomenon through the concepts of bounded rationality and bounded reliability, while assuming economizing properties of this practice. Yet, the TCE-based analysis of trading favors presented here is not without its limitations.

While enabling sound prescriptions based on trading favors' economizing properties, TCE does not address fully complex ethical and moral questions related to this practice, nor its anthropological roots and social embeddedness. Further, though TCE acknowledges the possibility of power asymmetries and can actually address the related governance challenges when these asymmetries are endogenous (e.g., resulting from managerial choices), it does not offer an optimal response in cases of extreme, exogenously imposed power asymmetries. The latter include, *inter alia*, cases of giving in to extortion where kidnapping of employees is involved. The strength of TCE, though, is that this lens can easily accommodate complementary perspectives. Other theoretical approaches can be productively utilized to complement conventional TCE analysis and predictions. For example, the internalization theory version of TCE, which blends the Coasean transaction cost economizing perspective with the resource-based and dynamic capabilities views of the firm, can add value by analyzing the linkages between trading favors and firm-specific advantage (FSA) development patterns. As one example, in the case of transactions between a large multinational enterprise (MNE) operating in an emerging economy and a local partner with strengths in national responsiveness, one would expect trading favors to occur for: (1) MNE products involving "old technologies" rather than those embodying the MNE's newest technologies and related FSAs, and (2) local services that may be difficult to access by the MNE but can easily be deployed by the local partner through economies of scope, and without having to dedicate "production capacity" in an exclusive and costly fashion to the MNE (e.g., networking contacts).

Finally, it may be useful to reflect on future research directions. Emerging economies, frequently associated in the literature with trading favors, offer a particularly interesting situational context for trading favors analysis. First, emerging economies are often characterised by the presence of U-curve institutional conditions, including elements of both institutional vacuum and overkill (e.g., in terms of protectionist local policies). These conditions facilitate testing the trading favors U-curve hypothesis at the macro-level. Second, trading favors practices are comparatively more visible in emerging economies than in developed countries, partly because of their higher legitimacy and open acceptance. Third, encouragement versus discouragement of trading favors in emerging economies may have substantial, and again very visible, distributional implications for MNEs and local economic actors. Fourth, both institutional and cultural specificities, as macro-level shift parameters, influence the application and impacts of trading favors in each emerging economy. Such specificities should allow for useful comparisons among these nations, and in our view this represents a fascinating, multidisciplinary research opportunity.

As a closing note, our study has important practical implications for managers and policy-makers alike: trading favors is not synonymous with unethical business practices and therefore does not necessarily need to be fought as a societal evil. Its often deep societal roots would make fighting it difficult, if not futile. The managerial challenge is not to chase trading favors from governance design and from conducting transactions, but rather to understand how to use it efficiently, and to focus on appropriate enforcement mechanisms to ensure a mutually beneficial, reciprocal exchange, while preventing negative spill-overs.

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