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International standards certification, institutional voids and exports from developing country firms

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ABSTRACT

This paper analyses the impact of International Standards Certification (ISC) on the export participation and the scale of exports of firms based in 89 developing or transition countries. We conceptualise ISC as an endogenous institutional advantage, which bridges institutional voids in the country and helps firms to export. The empirical results show that certified firms are more likely to export, and to export on a larger scale. The impact of ISC runs through two channels: productivity and transaction cost economies. We show that certification plays an important role in bringing down transaction costs in international markets, while also maintaining and raising efficiency. This finding is reinforced by additional evidence, suggesting that ISC matters more for the export participation of domestic firms than for foreign firms and is of greater importance for firms based in countries characterised by severe institutional voids.

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1. Introduction

There is a strong consensus among scholars that the international competiveness of companies and nations strongly depends on supporting institutions (Peng & Meyer, 2011). Institutions constitute the 'rules of the game' that reduce uncertainty in transactions and shape economic interactions (North, 1991). Efficient institutions, which allow the measurement and enforcement of transactions at a low transaction cost, are key to superior economic performance and global competitiveness.

Recent work has pointed to 'institutional voids' in many developing, emerging and transition countries – whereby institutional arrangements that are meant to foster transactions are either weak or absent. Institutional voids typically reveal a lack of specialised intermediaries to help provide economic agents with necessary information, (human) capital and contract enforcement mechanisms (Khanna & Palepu, 1997). They may also signal an abundance of political, social or religious institutions that are conflicting and hinder the efficiency of markets (Mair & Marti, 2009). Institutional voids raise transaction costs for multinational firms willing to set up business in institutionally weak countries (Khanna, Palepu, & Sinha, 2005), but may also complicate the engagement in international activity for domestic firms. In cross-border trade, institutional voids may originate from missing dispute-settlement mechanisms and other important trade-related institutions, in addition to voids resulting from the mere differences in the cultural and institutional set-up of countries (Ricart, Enright, Ghemawat, Hart, & Khanna, 2004).

While institutional voids hinder market functioning in general, various ways for bridging institutional voids have been documented. The international business strategy literature shows that multinational enterprises (MNEs) can internalise some of the specialised intermediaries' tasks by establishing their own supply chain and management systems and using their reputation and brand name to signal quality and reduce transaction costs (Khanna et al., 2005; Ricart et al., 2004). The presence of MNEs can even directly address institutional voids, when quality products or services with a specialised intermediary function are being offered to local companies (Khanna et al., 2005).

Small and medium sized enterprises (SMEs), however, have more limited resources, and need to work around institutional

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voids. The voids bridging mechanisms discussed in the literature include informal business networks providing surrogate specialised services to group members (Khanna & Palepu, 2000); clusters providing resources, information and consultancy support to cluster firms in a more formal setting (Schrammel, 2014); CSR initiatives opening access to resources (El Ghoul, Guedhami, & Kim, 2017) and CSR-reporting practices helping firms to overcome 'liabilities of foreignness' (Marano, Tashman, & Kostova, 2017) in a more transparent environment.

Less attention has been devoted to the role of international management standards in the context of institutional voids. Being increasingly important in international transactions, over the last few decades of globalisation, the development of international standards and the adoption of standards by companies have steadily increased (ISO, 2014).[1] The most widely diffused standards are ISO 9000 for quality management and ISO 14000 for environmental management. The literature on standards certification and its diffusion has shown that international management standards improve firms' managerial and operational efficiency (Sampaio, Saraiva, & Rodrigues, 2009) and reduce transaction costs in trading relations by signalling a firm's superior quality performance (King, Lenox, & Terlaak, 2005; Potoski & Prakash, 2009; Terlaak & King, 2006). Firms can voluntarily implement standards by way of self-regulation, requiring firms to take action *beyond* what domestic government regulations and institutions stipulate. When government regulation is ineffective, standards can act as a surrogate institution, by putting firms on common ground in terms of managerial practice, business language and conflict-settling procedure, reducing the institutional distance between them. In this paper we argue that standards work as an institutional voids bridging mechanism that helps firms to be successful in foreign markets, by improving firms' efficiency and reducing transaction costs. This mechanism is more important when institutional voids are more severe.

Firms active in global markets increasingly rely on standards to control their local suppliers and to coordinate international production. They use standards to protect their corporate reputation and to shelter from the growing pressure of activist and consumer groups, and other stakeholders (Kaplinsky, 2010; OECD, 2015). Hence, lead firms in global value chains require local suppliers to demonstrate a commitment to quality, environmental sustainability and decent labour conditions. This commitment takes the form of a certificate that documents implementation procedures and demonstrates adherence to the appropriate internationally agreed management standards. Certification requires the firm's management system to be audited on a regular basis by an accredited certification body that issues a certificate of conformity if the standards required have been met.

The role of standards adoption and certification in international trade has been the subject of recent research using macro data. Potoski and Prakash (2009) find that ISO 9000 certification levels are associated with increases in countries' bilateral exports, particularly in the case of developing countries, which may be due to the relative severity of their quality assurance challenges. In a similar way, Clougherty and Grajek (2008) find that ISO diffusion has no effect in developed nations but enhances exports from developing countries. The authors underscore the role of certificates as a substitute institution, reducing information asymmetries and transaction costs in developing countries with uncertain business environments.

This paper takes the analysis to the micro level – the level at which certification should have its direct impact – to validate and deepen this finding. Using firm-level data from the World Bank Enterprise Survey, we study the export engagement of firms from 89 transition, developing and least developed countries in relation to firms' standards certification. About 90% of the firms are SMEs with fewer than 250 employees. The countries show varying levels of economic and institutional development but, compared to industrialised countries, score medium to low on the World Bank Doing Business Index, indicating the existence of important institutional voids in the countries of our sample.

We make several contributions to the literature. First, we develop a conceptual model explaining how international standards certification fits within the eclectic paradigm of international business and helps to overcome institutional voids affecting the export engagement of firms based in less developed markets. In doing so, our paper contributes to three bodies of literature: international business, development studies and the literature on standards and their diffusion. Second, we disentangle the export engagement of the firms in two constituent elements: export participation or the decision to be an exporter (1) and the scale of exporting (2) and we examine the effects of certification on each of the two elements. Third, we uncover and provide evidence on the relative importance of the two channels through which certification has an impact on the export engagement: productivity gains associated with the development of dynamic capabilities (channel a); and reduction of transaction costs (channel b). Fourth, we investigate if the transaction economies from certification are of greater importance for firms in countries characterised by strong institutional voids. Fifth, we analyse if certification matters more for domestic firms than for subsidiaries of foreign firms, which tend to internalise institutional voids by developing their own internal standards and support systems.

The paper is structured as follows. Section 2 develops the conceptual model and associated hypotheses. Section 3 develops the empirical approach, and presents the data and the estimating model. Section 4 presents the empirical results. Section 5 discusses our main findings and conclusions.

2. International standards and export performance: conceptual model and hypotheses

The decision to export and resulting performance in international markets is typically studied in the International Business literature within the evolutionary framework of the eclectic paradigm which centres around three key constructs: ownership (O), location (L) and internalisation (I) advantages. The framework emphasises the heterogeneity of firms in the way they develop and combine the three advantages. Exports are taken as the outcome where firms combine ownership advantages (most often measured by the demonstrated productivity of the firm), with home country location advantages – provided export transaction costs are not too high (Cantwell, 2015). *Ownership* advantages refer to the technological and company specific advantages which enable the firm to overcome the cost of entering foreign markets and to compete successfully in international markets (Dunning, 2000). More recently, Dunning and Lundan (2010) emphasised institutional advantages as being part of the ownership advantages. Institutional advantages cover the range of formal and informal institutions that govern the value-added processes within firms. The origin of these advantages is partly exogenous and partly endogenous to the firm. The exogenous origin derives from the degree to which the informal (and formal) institutions in the firm's home country have impacted the way in which incentives are set within the firm. The endogenous origin is the result of entrepreneurial or managerial activity, including mission setting, culture or, as we argue in this paper, the adoption of international standards within the organisation. *Location* advantages reflect

[1] This is reflected in the continuous rise in the numbers of ISO management certificates issued worldwide, with a 4% increase in 2013 alone (ISO, 2014).

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