New Zealand Asia Institute

Research snapshots

No. 20

The New Zealand Asia Institute (NZAI) undertakes research focusing on engagement with Asia, provides a forum for informed debates, and offers a bridge to Asia-related expertise and research within the University of Auckland.

Why do Firms Locate Close to Others? The Influence of Institutions on Supplier Firms

Industrial activity tends to concentrate, or cluster, differently in different countries. Could institutions, in the sense of formal or informal rules that structure behaviour, influence such clustering? New international trade research explores this possiblity.** Taking the legal enforcement of contracts as an indicator of formal institutional strength, it asks whether US importers source in a more – or a less – spatially concentrated way from suppliers in institutionally weaker countries.

The researchers used confidential US merchandise customs data. They then adapted an existing measure of economic concentration to tease out the concentration of suppliers chosen by US importers from exporters' own natural tendency to cluster. Data capturing the cost, time and number of procedures involved in legally enforcing contracts was extracted from the World Bank's Doing Business project.

After controlling for, among other things, nations' levels of development and how dense their population and economic activity generally are, the study found US importers sourced in a more spatially concentrated way in countries where legally enforcing a contract required more procedures and/or a longer time.

Two further, alternative measures of institutional strength bore out the results for measures based on contract enforcement. These were countries' legal systems (English-derived common law, for instance) and property rights; and freedom from corruption.

The results firmly link weaker institutions to a more concentrated choice of suppliers. What was driving this, though? Analysis suggested it was not just that in an institutionally weaker nation economic activity might, say, focus on one megacity that dwarfs the rest. Nor did it seem to be just that some suppliers were intermediaries – who might naturally cluster at distribution centres like ports – rather than manufacturers.

Instead, the researchers argued for a third causal channel: informal supplier networks. Through smoother information flows and informal sanctions for contract breaches, networks of neighbouring suppliers can lower the cost to importers and exporters of matching up with each other and transacting. Wherever institutions and the rule of law are weak, higher risks and set-up costs would make an importer less tempted to venture out to a cheaper supplier in an unfamiliar city, since local business networks in their current city would offer ready, reliable information about doing business locally and about input suppliers' reputation and dependability.

Although there was no direct evidence on the role of supplier networks, there was indirect support: concentration was greater in more contract-intensive industries, meaning those whose inputs are relationship-specific and not bought or sold in an exchange or reference-priced.

This study contributes to knowledge not only of international trade and urban agglomeration but also of how informal institutions can foster economic activity. It suggests that, when strong formal enforcement institutions are missing, informal local cooperative networks help fill the gap, reducing agency and other transactions costs.

**The full study results are available in an article by Fariha Kamal and Asha Sundaram: "Do institutions determine economic geography? Evidence from the concentration of foreign suppliers". Journal of Urban Economics 110, 89-101, 2019.

THE UNIVERSITY OF AUCKLAND
Te Whare Wānanga o Tāmaki Makaurau
NEW ZEALAND

NEW ZEALAND ASIA INSTITUTE