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Ethical Distance and Difference in Bilateral Trade

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Abstract

Cultural, institutional, and psychic distances between countries are critical determinants of bilateral trade. In this paper we examine if ethical distance and difference between an exporting country and an importing country matter in international trade. Ethics in international trade is important because purchasing, exports, marketing and sales activities are more likely to involve unethical behaviors like bribery and corruption. The focus of the paper is on the similarities and differences in ethical behaviors between a trade dyad (an importing and an exporting country). We ask if variations in perceived ethics among the protagonists help or hinder bilateral trade. More specifically, we examine if countries that are ethical trade more or less with other similar countries. Using data from 53 countries that participated in the World Values Survey, we show that the closer the ethical distance between countries the greater the trade. We also find that the ethicality of importers matter more than exporters as a determinant of bilateral trade.

Keywords: Ethics, Ethical Distance, Ethical Difference, Determinants of International Trade, Cultural Distance

JEL Codes: F11, F13, M14

Ethical Distance and Difference in Bilateral Trade

1. Introduction

International trade has been an engine of global economic growth for centuries and in particular, over the last 50 years. Countries affected severely by the 2008 Global Financial Crisis like the United States (US), Japan and Germany resorted to exports as a conduit to scramble out of the economic malaise. It is not surprising then that international trade researchers have been pre-occupied with the determinants of international trade. Trade theorists have explained trade directions based on factor endowments (postulated by Heckscher-Ohlin) and economies of scale in differentiated products (postulated by new trade theorists like Krugman, Helpman and others). While the former explained trade between developed and developing countries, the latter provided insights into intra-industry trade among countries with similar factor endowments (Salvatore, 2001). More recently, there has been a surge in research unveiling other country level differences that could add to our understanding of those factors that stand as drivers of bilateral trade as well as its obstacles. These studies tend to focus on the institutional distances that exist between countries, defined in a broader context as, "*humanly devised constraints that structure political, economic and social interaction... [and that] provide the incentive structure of an economy...*" (North, 1991, p. 97).

Thus, previous studies have considered formal factors including regulatory, political and economic institutions, as well as informal factors like social norms, beliefs and values. These institutional differences among countries contribute to the intangible transaction costs and may explain why bilateral trade continues to be dominated by similar countries (Rauch, 2001; Helpman, et. al., 2008). Given that a range of factors have been considered in the past - from currency unions (Rose, 2000) to the Dalai Lama effect (Fuchs and Klann, 2010) – the objective of this paper is to extend further the search for meaningful determinants of international trade. We focus our attention on the similarities and differences in ethical behaviors between a trade dyad (an importing and an exporting country) and ask if variations in perceived ethics among the protagonists help or hinder bilateral trade. Ethics in international trade is important because purchasing, exports, marketing and sales activities are more likely to involve unethical behaviors like bribery and corruption (Transparency International, 2006; Baughn, et. al., 2010). Intuitively, one could argue that both sides of the trade dyad would prefer having a trustworthy and ethical trade partner so that some risks are minimized. This leads us to examine if *ethical difference* matters. Furthermore, disagreements may result from cultures applying dissimilar moral/ethical values to business activities (e.g. difference in attitudes towards bribery, sustainable development, etc.), which leads us to examine if the relative *ethical distance* matter. In the next section we review the literature on the determinants of international trade, paying particular attention to the softer drivers of trade and the rationale for our hypotheses. In section 3, the data and methodology employed are discussed, followed by a discussion of the results of our analysis. Finally, in section 5, we conclude by proposing some implications of our findings.

2. Determinants of bilateral trade and proposed hypotheses

Differences that exist between countries motivate firms to trade across borders, just as differences among individuals forces exchange. Early international trade theories tend to explain the sources of differences – whether due to differences in factor productivity (David Ricardo) or in factor endowments (Heckscher-Ohlin). Newer trade theories however emphasize similarities between countries to explain the nature of trade. In particular, economies of scale advantages and the desire for greater varieties are reasons given for greater intra-industry trade (Helpman and Krugman, 1985; Krugman, 1980). Intra-industry trade is likely to be larger among countries of similar size and factor proportions, as evidenced by trade among Western European countries (Greenaway and Milner, 1986).

The tradition of identifying commonalities among countries to explain bilateral trade has been a focus of attention in recent years. The underlying logic behind the reason why countries that are more similar tend to trade more with each other is transaction costs. Bae and Salomon (2010) suggests that various distances among countries, whether political, regulatory, economic, cultural or cognitive are manifested in the "liability of foreignness" (Hymer, 1960) which results in an increase of various costs including coordination, knowledge transfer, labour and legal costs for the trading firm. To minimize this liability, international exchange tends to take place among firms from more similar countries. Thus, countries that share a common border, a common language, a common history (eg. colonial master), a common currency and a common political system have a greater likelihood of trading more with each other (Frankel, et. al., 1998). It can be argued however, that these commonalities stem from the similarities in values, behavior and attitudes (or in a general sense, culture) of the people in the two countries. Lewer and Van den Berg (2007) for instance, found that religious similarity (which implies a similar value system) could encourage international trade by enhancing the network effects within members of a common religion. Scholars from the Uppsala school (Johanson and Vahlne, 1977) have argued that economic exchange relies on the transfer of information, which in turn is based on some implicit symbols and values. Thus, managers would find it much easier to deal with counterparts from countries that are closer in terms of psychic distance (Siegel, et. al., 2008).

Indeed, the importance of having shared values among business partners has been extensively researched in the exchange theory literature both at the consumer and firm level. A general consensus on ethical values between two parties decreases the distance between firms. Morgan and Hunt (1994, p. 22) defined "shared values" as "the extent to which partners have beliefs in common about what behaviors, goals, and policies are important or unimportant, appropriate or inappropriate, and right or wrong". Several studies find that having shared values increases trust and commitment among parties (Dwyer, et. al., 1987; Morgan and Hunt, 1994). Carter (2000) examined the ethical issues surrounding the relationships between 88 paired United States' buyers and their foreign suppliers and suggested that the gap between a buyer's and supplier's perceptions of unethical behavior (deceitful practices) on either side would negatively influence the relationship. Sharing a similar ethical view, on the other hand led to a satisfactory buyer-supplier relationship. The seminal work by Guiso, et. al. (2009, p. 1098) on intra-European Union trade found that "a one-standard-deviation increase in the importer's trust toward the exporter raises exports by 10%". The level of trust, according to these authors, can be explained by shared culture, religion, ethnicity as well as somatic distances, among others.

The arguments above propose that dyads with shared ethical values trade more with each other because of lowered transaction cost. The proposition is more likely to hold when both parties are ethically righteous. In contrast, the previous studies on exchange between dyads that are lower on ethical standards are limited. Countries with lower ethical standards may have no choice but to trade with partners of similar ethical standards. In the study on China's outward Foreign Direct Investment (OFDI), Child and Rodriguez (2009) claimed that Chinese firms prefer to invest in countries with similar opaque political environment (eg. Angola, Democratic Republic of Congo etc.) - and by implication dubious ethical practices. Recent empirical findings by Ramasamy, et. al. (2011) confirm the smaller liability of foreignness faced by Chinese firms in such foreign locations. The propensity that firms from a country acting unethically (for instance, providing bribes) in international transactions reflects the attitude towards ethical practices at home (Baughn et.al., 2010). Similarly, there is also a greater likelihood that tolerance towards unethical practices in the host country is condoned at home (Sung, 2005). In a study of bribes in international transactions among 29 countries, Baughn et. al. (2010) found that in countries where corruption is tolerated, bribery tends to be carried over to partner countries. These limited findings tend to imply that exchange between parties that are equally unethical may also be significant.

Since the international trade between two countries is the sum of trade relationships between exporters and importers, we hypothesize that:

> H1. The larger the ethical distance between dyad members, the smaller the bilateral trade among the two parties.

Unlike culture, the ethical position of a country vis-à-vis its exchange partner should also influence bilateral trade. While studies that consider cultural and psychic factors (Kogut and Singh, 1988; Dow and Karunaratna, 2006; Xu and Shenkar, 2002) could only measure the distance between countries, the relative position was ignored as the construct was unable to define "good" or "bad" culture. Siegel et. al. (2008) attempted to consider the directional (or signed) nature of culture but fails to provide any justification for their results. Guiso et. al. (2009) study of trust (a construct that could imply direction) in bilateral trade considered only a one-way relationship i.e. the degree to which the exports of country j to country i is affected by the level of trust among citizens in country