A Transaction Cost Analysis

Outsourcing Production to China

By L.J. Jongerius & R.J.C. Sie

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Preface

This report was made for Stichting Handelsland by Robin Jun Cai Sie and Lars Jens Jongerius. The idea for this project, initiated by Stichting Handelsland, was fueled by the recognition that much of the costs involved in outsourcing initiatives, although significant, are not comprehensively recognised by practitioners. These unrecognised costs primarily consist of transaction costs. Stichting Handelsland argues that gaining insight into the size of these transaction costs is a fundamental step toward improving international trade, or rather toward improving the competitive position of Dutch private and public organisations in international trade. By reducing the transaction costs of trading, something which may be considered a core competence of the Dutch (Den Butter, 2009), both the private and public sector can benefit. The authors are thankful to have the opportunity to contribute to, and be involved in, this ambition of Stichting Handelsland.

To ensure the practical relevance of this project, the report is a result of both a literature study and interviews. By literature study we mean sources with a practical orientation; the use of academic sources was minimised. With respect to the interviews, we are very grateful for the contribution of those people who have made time to share their knowledge with us. Therefore, we would like to thank the following persons:

Mr. N. Boerma; Mr. F.A.G. den Butter; Mr. J. Buiter; Mr. A.K. Zwart, Ms. A.J.M. van den Breemer; Mr. G. Scheringa; Mr. G.E. Gjaltema; Mr. H. van Dalen; Mr. S. Mulder.

Amsterdam, September 2009
**Table of Content**

1. **Introduction**  
   page 03
2. **What is Outsourcing?**  
   page 05  
   2.1. Types of Outsourcing  
   page 05  
   2.2. Motivations for Outsourcing  
   page 07
3. **What are Transaction Costs?**  
   page 08  
   3.1. A Short Academic Introduction to Transaction Costs  
   page 08  
   3.2. Transaction Costs in Outsourcing Production  
   page 09
4. **Transaction Cost Analysis**  
   page 09  
   4.1. The Outsourcing Process  
   page 09  
   4.2. The Identification of Transaction Costs  
   page 23
5. **Discussion**  
   page 60  
   5.1. Theory and Practice: Discrepancies  
   page 60  
   5.2. Market Outlook for Outsourcing to China  
   page 67
6. **Limitations and Recommendations for Future Research**  
   page 72
7. **References**  
   page 75
1. Introduction

The primary purpose of this report is to identify the transaction costs involved in an outsourcing initiative. By the end of this report, the reader should be provided with a view of what outsourcing entails in terms of transaction costs, what potential risks are involved in outsourcing, and how some of these risks can be mitigated. In writing this report, some choices were made as to limit the scope of the project. One can imagine that although countless contingency factors and scenarios can be incorporated, this would only lead to confusion. A selection was therefore made as follows:

First, den Butter (2009) recognises four strategic issues that impact the decision to move production abroad: (1) the size of the transaction costs involved in the outsourcing initiative; (2) the price-elasticity of demand (can potential productivity gains be subtracted from the consumer price); (3) the development of wages in the outsourcing country; and (4) the development of wages in the home-country. This last issue, Den Butter argues, also involves possible retraining of employees in the home-country.

This project focuses primarily on the first issue of transaction costs’ magnitude. A limited part of the report is dedicated to the development of wages in the outsourcing country (in the market outlook section) because of its relevance to the Chinese economic situation. The price-elasticity of demand and the development of wages in the home-country have been left out, and is perhaps a topic for future study.

The second choice is whether to focus primarily on importing or outsourcing. This report focuses on outsourcing because it entails a larger part of the process by also including the impact on an existing organisation. This is not necessarily the case for importing. We believe that focusing on outsourcing should provide a more comprehensive result, which includes the majority of importing transaction costs.

The third choice is based on the model by Gattai (2005), which combines the make-or-buy decision and location. The four resulting options are: (1) continue production in the home-country; (2) move production abroad via a FDI (foreign direct
investment) and thus producing oneself; (3) outsource production in the domestic market; (4) and outsource to a foreign market (such as China). Although the list of transaction costs reflects the costs involved in making the choice between these four alternatives, the focus is on the latter option: outsourcing to a foreign market.

Fourth, with regard to one-time investments and recurring investments, this report incorporates both. Though not explicitly differentiated, it can be argued that the analysis phase entails mainly one-time investments, whereas the engagement- and process- phase also contain recurring costs. These phases will be discussed in the transaction costs analysis section.

The following structure should support the primary purpose of identifying transaction costs outsourcing initiatives to China: First, a section (2) aims to provide clarity on different aspects of outsourcing. This section is followed by a section (3) that intends to create a basic understanding of transaction costs. Next (4), an explanation is given of the way the approximately 240 transaction costs are structured in phases, stages, and categories. These transaction costs are those costs that can be encountered when outsourcing to China. This section continues to provide a list of transaction costs, in which each of the costs is shortly elaborated on. The section hereafter (5) incorporates interesting findings of our research. This section discusses the main results of the interviews, shows how some of the outsourcing processes in practice diverge from the earlier discussed list, and provides a short market outlook that discusses issues that may impact outsourcing processes in China.

The coming two sections will serve as a basic foundation to those who are not yet familiar with outsourcing initiatives and transaction costs.
2. What is Outsourcing?

Sourcing is the act of transferring work from one entity to another. Outsourcing then is the act of transferring work to an external party. In other words, an organisation agrees to let another organisation (third-party) perform activities for them that they used to perform in-house. An organisation that outsources its internal business activities is called a *client* in this report, or referred to as the *organisation*. The organisation that provides outsourcing activities is called the *vendor*.

2.1 Types of Outsourcing

There are many kinds of outsourcing categories and models, each with its own strengths and weaknesses, and management concerns. This section provides an overview of three categories of outsourcing, they are based on: (1) location; (2) depth; and (3) work.

**Location**

Outsourcing can be categorised by manner of where the vendor’s work is conducted: (1) on-site or off-site. On-site implies that the vendor’s employees work within the premise of the client’s organisation. An off-site location refers to the vendor working at its own organisation’s location. The off-site work arrangement can be subdivided into (a) onshore; (b) near-shore; and (c) offshore.

*Onshore* outsourcing takes place within the same country as the client. In such a situation, activities initially performed internally usually relocate in peripheral areas, where vendors can often charge lower prices and where living costs are lower. Onshore outsourcing has advantages in the form of fewer cultural issues and when the activities are of sensitive nature (security- and privacy risks that prevent it from being outsourced abroad). *Near-shore* arrangements involve moving the outsourced activities to neighbouring countries. Advantages of near-shoring comprise of relatively small cultural differences, cheaper travel and communication costs than offshoring, and no major time zone differences. Some prime examples of near-shore arrangements are Western Europe and Eastern Europe, as well as the United States and Canada. *Offshore outsourcing*, or *offshoring*, refers to work sent to
countries that are at a considerable distance from the client. Offshoring has primarily been made possible by two changes in the business environment. First, the capacity improvement of international telecommunications and the associated reduction in global telecommunication costs. Second, the computerisation and digitisation of most business services has made offshoring possible. Because of these two changes, long-range information transferring became relatively easy and low cost. Consequently, organisational- and national boundaries are significantly less important in deciding the location of production and service functions.

**Depth**

Outsourcing projects can also be categorised according to their depth level: (1) individual; (2) functional; or (3) competency. Outsourcing specific positions within the organisation refers to *individual* outsourcing. Individual outsourcing is the simplest form of outsourcing and is initiated when organisations need expertise in a particular area and for a specific time period. *Functional* outsourcing entails the outsourcing of a single functional area. Often, the client organisation achieves cost advantages and considerable expertise because of the vendor’s economies of scale in a particular domain of work. *Competency* outsourcing regards outsourcing activities that control how products and/or services flow through organisations. This kind of outsourcing is the highest-order construct within the depth category.

**Work**

Outsourcing activities can also be categorised according to the nature of the work. The work can either be (1) process-oriented or (2) project-oriented. Process-oriented work involves the outsourcing of structured, standardised, and documented processes. An example of process-oriented work is the outsourcing of payroll functions. When one outsources unique and non-routine work, such as research and development, this work is referred to as project-oriented work.
In figure 2a, the various types of outsourcing are depicted. The grey areas display the scope of the outsourcing process we discuss in this report.

2.2 Motivations for Outsourcing

There are three main motivations to consider outsourcing:

1. **Cost savings** – the main reason given for engaging in outsourcing is saving on costs. These cost savings can be realised in a number of ways. First, the savings can be derived from a move from fixed to variable costs. This could for example mean that an organisation no longer pays for the acquisition, upkeep, and maintenance of the resources it owns. Rather, the organisation now only pays a fee when it uses the assets or accesses them. Second, cost savings can come from outsourcing work (often to developing countries), thereby reducing the cost of labour. Third, beneficial tax regulations and other foreign-trade agreements can motivate an organisation to outsource certain activities.

2. **Access to resources and knowledge** – nowadays, having access to resources and knowledge is considered to be more important than owning them. For an organisation it is not economically rational to be self-sufficient. The main reason is opportunity cost. If organisations attempt to perform all activities themselves and spend all their resources to create expertise, skills, and technology, they are underutilising their resources. It is likely that there are other organisations that
are able to provide access to vital resources at a lower cost than it would take the particular organisation to produce these resources.

3. **Focus on core competence** – core competences are an organisation’s unique skills, talents, and capabilities. When an organisation outsources activities, it not only transfers the performance of activities, but it also transfers decision rights and accountability. In doing so, the organisation is able to focus more on the activities that it does best.

To most organisations, China seems an attractive destination for outsourcing production thanks to the cost savings (primarily in labour costs). However, as mentioned before, transaction costs are often overlooked even though they play a significant role in determining the feasibility of outsourcing to China.

### 3. What are Transaction Costs?

3.1 **A Short Academic Introduction to Transaction Costs**

Transaction costs were first introduced in economic theory by Coase (1937). He argued that transaction costs resulted from using the ‘pricing mechanism’. Transaction costs are all the costs that the functioning of the market entails. These costs include ex ante costs such as drafting and negotiating contracts, as well as ex post costs like monitoring and enforcing agreements. The theory of transaction costs has primarily been developed by Williamson (1991), who defined transaction costs as ‘the costs of running the economic system’. Nowadays, the term ‘transaction cost’ is mainly related to the transaction itself: it involves all costs associated with the commencement, execution, and the compliance of a transaction (Den Butter, 2009). Coase (1937) argued that firms and markets are alternative governance structures that differ in transaction costs. Williamson (1975) complemented this contention by adding that transaction costs include both the direct costs of managing relationships and possible opportunity costs of making inferior governance decisions. In other words, under certain conditions the costs of conducting economic exchange in a market (outsourcing production) could exceed the cost of organising the exchange within the firm (in-house production).
3.2 Transaction Costs in Outsourcing Production

Outsourced manufacturing is becoming standard practice in many industries, from simple toys to high-tech computer chips. Whether or not to outsource is the decision of whether to make or buy. Organisations are continuously faced with the decision of whether to expend resources to create an asset, resource, product, or service internally, or to buy it from an external party. If the organisation chooses to buy it from an external party, it is engaging in outsourcing.

4. Transaction Cost Analysis

4.1 Categorisation

To guide our research about transaction costs involved in outsourcing to China, we created a framework of approximately 240 transaction costs that could theoretically be involved in the outsourcing process. In order to create this framework, several sources were used that can be found in the reference list.

The broad categorisation of these transaction costs is a distinction between the analysis phase, the engagement phase, and the process phase. The analysis phase is characterised by four stages. First, we have the strategic assessment stage, which entails a preliminary assessment of the strategic feasibility of the project. Second, we implemented a needs analysis stage that is concerned with general information of important aspects of the outsourcing process. Third, we have a vendor assessment stage in which a thorough assessment of potential vendors is conducted. And fourth, the assessment of other service providers stage, which provides an overview of the services of other potentially useful third parties.

The engagement phase is concerned with forging contracts with third parties and the actual outsourcing process from a logistics perspective. This phase consists of two stages: a contract and negotiation management stage, in which contracts are formulated through a process of negotiation, and a logistics stage, which describes the different steps in the process of getting the products from China to the Netherlands.
The process stage focuses on the *relationship management* with third parties and *continuance-, modification-, and exit strategies*.

The categorisation is depicted in figure 4.1 below. Each of the stages will be discussed in more detail in the sections that follow.

![Figure 4.1](image-url)
Analysis

The four stages of the analysis phase can further be subdivided into several categories. These categories each contain multiple transaction costs, which will be specified in the following section.

The strategic assessment stage clarifies whether an outsourcing project is in line with the strategic objectives of the organisation, whether the financial benefits appear to be significant, whether there is operational feasibility, and whether there are technological risks involved that cannot be overcome.

The needs analysis involves the initial information gathering on all general aspects of outsourcing to China. It provides an assessment as to the feasibility of the project in terms of the actors and the environment. At the end of the information phase it should be clear whom to contact and how to proceed with the partner selection.

After having gathered enough information on all general aspects of outsourcing to China, the organisation can begin with contacting potential vendors. An assessment of multiple aspects should result in the selection of the most competitive and competent business partners. In addition, the organisation should make an assessment of other third parties such as business representatives and handling agents to clarify which services are a necessity. Also, different government levels within China might have an interest in your organisation that you should know about.

The categories per stage are depicted in figure 4.2 on the following page. Thereafter, the transaction costs related to these categories will be discussed.
Figure 4.2
Analysis: Strategic Assessment

The strategic assessment stage of the analysis phase starts with the assessment of strategic aspects. In case of outsourcing there will be an organisation in place with a strategy. The impact of outsourcing (part of) an activity on the organisational strategy should be considered. The organisation should also make sure that there is support for initiating the outsourcing process. The broad outlines of the project should be defined and it should be made clear what location (country) best suits these broad project criteria.

The second category, financial aspects, should give insight into what the financial impact will be of outsourcing (part of) a business activity. Generally speaking, production costs and transaction costs should be considered.

Third, there is likely to be operational impact of some sort. Parts of the organisation may become obsolete and new functions may arise for coordinating the outsourcing process. It should also be clear what the potential costs are if the outsourced activity must be brought back in-house.

Finally, depending on the product, property rights can be a critical point of concern. Are there any security guarantees when outsourcing the activity? An addition to the financial analysis mentioned before is the potential need for technological investment.

Each of the discussed categories can be found in figure 4.3.

<table>
<thead>
<tr>
<th>Strategic Aspects</th>
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<tbody>
<tr>
<td>- Determine Organisational Strategy Fit</td>
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<tr>
<td>- Ensure Outsourcing Support</td>
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<tr>
<td>- Determine Project Criteria</td>
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<tr>
<td>- Analyse Location According to Project Criteria</td>
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<tr>
<th>Financial Aspects</th>
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<tbody>
<tr>
<td>- Compare Production Costs of the Netherlands and China</td>
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<tr>
<td>- Assess Transaction Costs Encountered in the Outsourcing Process</td>
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<tr>
<th>Operational Aspects</th>
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<tbody>
<tr>
<td>- Assess Organisational Impact of Outsourcing Activities</td>
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<tr>
<td>- Analyse Costs of Bringing Production Back In-house</td>
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<table>
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<tr>
<th>Technological Aspects</th>
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<tr>
<td>- Assess Security Guarantees (Patents, Copyrights, Property Rights, etc.)</td>
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<tr>
<td>- Analyse the Need for Technological Investments</td>
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Figure 4.3
Analysis: Needs Analysis

Figure 4.4 shows each of the categories of the needs analysis stage. The initial categories entail more general information gathering. The start-up information category has to do with finding information on outsourcing from several sources. The mediating institutions information category consists of those transaction costs incurred to provide information on which mediators can assist the organization in the outsourcing process. Information on Authorised Economic Operators is relevant only to some businesses but may be an essential aspect in saving time and money later on in the trajectory of outsourcing. Thereafter, time has to be spent on finding out more about what can be expected from the Chinese industry: does it appear to be a country worth outsourcing to? And what are the major differences between different Chinese provinces? Not only Chinese industry and market information is relevant, the Dutch market should also be thought through. The product has to be imported through Dutch customs and possibly comply with Dutch quality criteria.

Having gained information on these topics, the issue of transport should be reviewed: both local transport in China and Holland, and the transport overseas. Local culture should not be disregarded with respect to China: what informal practices, culture etc. can the organisation encounter in China.
Analysis: Vendor Assessment

Because the success of an outsourcing initiative is largely dependent on the business partner in China, a thorough assessment of potential vendors may be crucial.

Initially, the organisation will have to specify the product needs in terms of quality, process etc. In addition, the evaluation process should be carefully planned. The transaction costs involved are combined under background preparation. The next step will be to make a list of vendors that are contacted for additional information (for as far as this is available).

In the vendor evaluation category, the costs of the vendor evaluation are bundled. This is based on the additional information provided by the potential vendors and additional research. Next, a preliminary selection can be made before doing a more in-depth assessment that will provide the organisation with a final business partner or business partners. Take into account that a visit to China is most likely needed.

Please see figure 4.5 for the before mentioned categories and related transaction costs.

<table>
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<th>Background Preparation</th>
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<tr>
<td>- Specify Products</td>
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<td>- Put in Place a Vendor Evaluation Team</td>
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<tr>
<td>- Check for Legal Stipulations Regarding a Vendor Evaluation Process</td>
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<tr>
<td>- Put in Place a Well-Defined Vendor Evaluation Process</td>
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<tr>
<th>Manageable List of Vendors</th>
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<tbody>
<tr>
<td>- Visit Trade Fairs</td>
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<tr>
<td>- List of Possible Suppliers from Different Sources</td>
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<tr>
<td>- Additional Vendor Information</td>
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<tr>
<td>- Wait for Vendors' Responses</td>
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<tr>
<th>Vendor Evaluation</th>
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<tr>
<td>- Location of Vendors</td>
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<tr>
<td>- Experience of Vendors</td>
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<tr>
<td>- Financial Robustness of Vendors</td>
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<tr>
<td>- Reputation of Vendors</td>
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<tr>
<td>- Capabilities and Strengths of Vendors</td>
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<tr>
<th>Vendor Selection</th>
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<tr>
<td>- Request Offers</td>
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<td>- Wait for Vendors' Responses</td>
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<tr>
<td>- Benchmark Vendors' Offers</td>
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<tr>
<td>- Evaluate Vendors' Understanding of Needs</td>
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<td>- Risk Assessment of Vendors</td>
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<tr>
<th>In-depth Vendor Assessment</th>
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<tr>
<td>- Check Sources of Vendors</td>
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<tr>
<td>- Request Sample Products</td>
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<tr>
<td>- Evaluate Sample Products</td>
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<tr>
<td>- Determine Vendors' Cultural Fit</td>
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<tr>
<td>- Check Vendors' Services to Competitors</td>
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<tr>
<td>- Cost-Benefit Analysis</td>
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<tr>
<th>Vendor Visit</th>
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<tr>
<td>- Cost of Preparation Trip</td>
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<tr>
<td>- Apply for Visa</td>
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<tr>
<td>- Costs of Visa</td>
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<tr>
<td>- Transport Costs</td>
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<td>- Accomodation Costs</td>
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<td>- Living Costs</td>
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<td>- Duration Trip</td>
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<td>- Risk of Small/ Daily Hazzards</td>
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<th>Vendor Approval</th>
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<tr>
<td>- Select Vendor</td>
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<td>- Communicate Selection to Vendor</td>
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Figure 4.5
Analysis: Assessment of Other Service Providers

Having decided upon which vendor(s) to use for the outsourcing initiative, the following step will be to make a selection of the other parties that can be involved in the process. Note that some of the mentioned service providers will be contacted earlier in the process because they provide services that can be of use in an earlier stage (such as assistance with finding the right business partners).

Whereas some of the third parties mentioned in figure 4.6 can hardly be excluded from the process (transporters and handling agents for instance), other parties may provide services that can also be done in-house. By requesting offers from each of the relevant parties, it becomes clear what the financial impact will be and whether the benefits will exceed the costs made for the service.

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<th>Transporters</th>
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<tr>
<td>- Specify Transportation Need</td>
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<td>- Create a List of Possible Transporters</td>
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<td>- Request Additional Information</td>
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<td>- Wait for Responses</td>
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<tr>
<td>- Transports’ Financial Robustness</td>
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<td>- Transports’ Reputation</td>
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<td>- Risk Assessment Transporters</td>
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<td>- Cost-Benefit Analysis</td>
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<td>- Request Offers</td>
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<td>- Wait for Responses</td>
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<tr>
<td>- Benchmark Offers</td>
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<td>- Select Transporters</td>
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<td>- Communicate Selection to Transporters</td>
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<th>Legal Service Providers</th>
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<td>- Request Offers Legal Service Providers</td>
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<td>- Evaluate Offers Legal Service Providers</td>
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<td>- Select Legal Service Provider</td>
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<td>- Costs of Legal Service Provider</td>
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<th>Due Diligence Agents</th>
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<td>- Request Offers Due Diligence Agents</td>
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<td>- Evaluate Offers Due Diligence Agents</td>
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<td>- Select Due Diligence Agent</td>
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<td>- Costs of Due Diligence Agent</td>
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<th>Translators</th>
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<td>- Request Offers Translators</td>
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<td>- Evaluate Offers Translators</td>
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<td>- Select Translator</td>
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<td>- Costs of Translator</td>
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<th>Advisors</th>
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<td>- Request Offers Advisors</td>
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<td>- Evaluate Offers Advisors</td>
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<td>- Select Advisor</td>
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<td>- Costs of Legal Advisor</td>
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<th>Business Representatives</th>
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<td>- Request Offers Business Representatives</td>
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<td>- Evaluate Offers Business Representatives</td>
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<td>- Select Business Representative</td>
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<td>- Costs of Business Representative</td>
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<th>Handling Agents</th>
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<td>- Request Offers Handling Agents</td>
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<td>- Evaluate Offers Handling Agents</td>
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<td>- Select Handling Agent</td>
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<td>- Costs of Handling Agent</td>
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<th>Quality Inspectors</th>
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<td>- Request Offers Quality Inspectors</td>
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<td>- Evaluate Offers Quality Inspectors</td>
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<td>- Select Quality Inspector</td>
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<td>- Costs of Quality Inspector</td>
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<th>Insurers</th>
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<td>- Evaluate Offers Insurers</td>
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<td>- Select Insurer</td>
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<td>- Costs of Insurer</td>
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<th>Accountants</th>
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<td>- Request Offers Accountants</td>
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<td>- Evaluate Offers Accountants</td>
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<td>- Select Accountant</td>
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<td>- Costs of Accountant</td>
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<th>Government Involvement</th>
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<td>- Information on Government Involvement</td>
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<td>- Assess Need for Government Involvement</td>
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<td>- Contact Government</td>
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<td>- Negotiate With Government</td>
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**Engagement**

The engagement phase, comprised of the contract and negotiation stage, and the logistics stage, is subdivided into seven categories.

In the first stage of engagement it is important to note that it is not self-evident to use a contract at all in China. It is up to the organisation and its vendors to decide upon using a contract, this topic will return later in the report.

When the organisation decides upon using a contract, transaction costs are made when defining the contract specifications and actually formulating the final contract together with the business partner(s).

The logistics stage first provides a category that lists the risks of the logistical process. This category is followed by the implications of problems encountered during quality control. Finally, the process is described from China to the Netherlands.

Please find the overview in figure 4.7.
Engagement: Contract and Negotiation Management

Once it is decided to use a contract, the organisation should identify key-components of the desired contract: from describing the roles of the parties to thinking through how to evaluate the performance of the business partner.

This provides the basis for the next step, which is actually formulating a contract. The organisation will likely start the contract formulation with finding a model contract, meeting with parties to assist in the process of contract formulation, etc. to eventually end with negotiating the final contract with the business partner.

Transaction costs made in this stage will differ as a result of how specific the contract needs to be and the extent to which third parties are used to perform part of the activities. In China, cultural nuances may influence the consideration of when to use third parties.

Figure 4.8 shows the two categories and the transaction costs involved for the contract and negotiation management stage.
Engagement: Logistics

After the contract formulation, the actual process of importing the product can be initiated. With this process, a number of risks can be involved. The first category of the logistics stage is therefore the logistical risks. This category includes all sorts of delays as well as the costs incurred to hedge or cope with risks.

Another potentially significant source of costs is the results of negative quality controls. In case the quality is not up to the standards several costs may have to be incurred.

Next, the process of importing is followed from placing the order to China, to transporting the product overseas, ending up in the Netherlands. Some of the costs are China-specific and some costs are relevant in case the decision is made to make use of a third party (e.g. an inspection company which inspects the cargo in China).

Figure 4.9 is an overview of these categories.
Process
The final phase, the process phase, considers the potential costs once the importing process runs. Investments may have to be made in the fields of relationship management, and continuance, modification, and exit strategies.

The first stage (relationship management) consists of one general category called cross cultural issues. This category includes multiple costs that arise from doing business with a different culture.

The second stage (continuance, modification, and exit strategies) consists of five categories. These categories contain those costs involved in evaluating the business and the context of the business. Other transaction costs arise from modifying the current business process and taking into account the possibility of ending the outsourcing process.

Please find the two stages and categories of the process phase in figure 4.10.
Process: Relationship Management
In the relationship management stage, the cross cultural issues category contains the transaction costs of having to build and maintain relationships with business partners.

Costs may arise from a diverse spectrum of issues: from problems in communication, resulting in a strained relationship, to trying to build guanxi (something that will require considerable time and effort). It will come as no surprise that the investment in these aspects of doing business in China will differ per situation and business. Nevertheless issues such as losing face are important to understand and hence to invest time in.

Figure 4.11 shows transaction costs that fall under cross cultural issues.
Process: Continuance, Modification, and Exit Strategies

The second stage of the process phase, and therefore the final stage, is the continuance, modification and exit strategies stage.

Once the importing process is up and running it remains of great importance to continuously evaluate all events relevant to this process. This may be internal events (at the organisation), external events (events in the environment), or events at the vendor’s business.

Then, once it becomes clear that the process or product requires modification, costs of these modifications, or of the results of these modifications, should not be overlooked.

Finally, under the category exits, costs incurred for revising the exit strategy and costs incurred for consequences of exit strategies are considered.

Please find the mentioned costs in figure 4.12.

![Figure 1.12](image-url)
4.2 The Identification of Transaction Costs

**Analysis**

1. **Strategic Assessment**

1.1. **Strategic Aspects**

1.1.1. Determine organisational strategy fit

→ *Before the organisation decides to outsource activities, it is important to assess whether an outsourcing strategy fits within the broader organisational strategy. Not doing so may bind the organisation to a long-term path that might have a negative impact on the overall growth prospects.*

1.1.2. Ensure outsourcing support

→ *Before proceeding to outsource, the organisation should assess managerial and employees’ support for the project to determine the projects feasibility [with the current staff].*

1.1.3. Determine project criteria

→ *Determine the expectations of the outsourcing initiative, and how these expectations translate into ‘minimum’ requirements for the project.*

1.1.4. Analyse location according to project criteria

→ *The organisation should research the plausible locations for the outsourcing initiative and assess whether these locations are in accordance with the project criteria. The organisation should answer the question of whether China is the optimal choice for the outsourcing initiative.*
1.2. **Financial Aspects**

1.2.1. Compare production costs of the Netherlands and China

→ *Determine whether outsourcing is an economically rational decision by comparing the production costs of the respective countries.*

1.2.2. Assess transaction costs encountered in the outsourcing process

→ *Make an assessment of the possible transaction costs the organisation can expect to encounter during the outsourcing process.*

*The list presented here provides a good understanding of transaction costs.*

1.3. **Operational Aspects**

1.3.1. Assess organisational impact of outsourcing activities

→ *Assess what changes will take place when the organisation decides to carry on with the outsourcing process. For a starting business, the question should be whether the organisation should attract additional staff. As for established organisations, it should be assessed how the organisational structure and culture will be affected.*

1.3.2. Analyse costs of bringing production back in-house

→ *The organisation should be prepared for the situation in which the outsourcing initiative fails to reap the anticipated benefits, creating an incentive to move production back in-house.*

1.4. **Technological Aspects**

1.4.1. Assess security guarantees (patents, copyrights, property rights, etc)

→ *Assess the extent to which the organisation can guarantee intellectual property in an outsourcing initiative.*

1.4.2. Analyse the need for technological investments

→ *The organisation should make an assessment of what kind of investments in technology are needed for the outsourcing initiative to be a success. An example of such a technology-related investment would be a quality control system.*
2. Needs Analysis

2.1. **Start-up Information**

2.1.1. **Search for importing guidelines/information**

→ *Find starters information on the basics of importing and outsourcing (e.g. the Chamber of Commerce Guide to Importing).*

2.1.2. **Find relevant events (seminars, trade fairs)**

→ *Relevant events can include seminars and trade fairs, and provide prospective outsourcers a lead to a network, products, and other information. A well-known Chinese trade fair is the Canton Fair in Guangzhou.*

2.1.3. **Conduct a personal network scan for relevant contacts**

→ *Many people have either direct or indirect contacts that can be relevant for specific projects or situations. It is therefore recommendable to assess whether one indeed knows such people and what they can mean for the outsourcing project.*

2.2. **Information on Mediating Institutions**

2.2.1. **Analyse services of advisors**

→ *Analyse what value-enhancing services advisors can provide. For instance, the Chamber of Commerce provides advisory services for starting entrepreneurs in the field of outsourcing.*

2.2.2. **Analyse services of business representatives**

→ *Analyse what value-enhancing services business representatives can provide. Commonly, business representatives can help in many of the activities that have to be performed in China.*

2.2.3. **Analyse services of handling agents**

→ *Analyse what value-enhancing services handling agents can provide. Handling agents can take over part of the logistics process, which can include documentation and transport management.*
2.2.4. Analyse services of regulatory service providers
   ⇒ Analyse what value-enhancing services regulatory service providers can provide. Regulatory service providers, such as lawyers, can help during contract formation and other situations in which legal support is preferred.

2.2.5. Analyse services of quality inspectors
   ⇒ Analyse what value-enhancing services quality inspectors can provide. Quality inspectors guarantee product quality at the offshore location.

2.2.6. Analyse services of translators
   ⇒ Analyse what value-enhancing services translators can provide. Translators tackle possible language barriers.

2.2.7. Analyse services of due diligence agents
   ⇒ Analyse what value-enhancing services due diligence agents can provide. Due diligence agents can assist the organisation in qualifying potential vendors.

2.3. Authorised Economic Operators (AEO) information

2.3.1. Find information on becoming an AEO
   ⇒ Authorised Economic Operators are trusted business entities to customs, which consequently results in more efficient transactions. EAO have a reduced chance of being subject to a cargo scan. Although this AEO-certificate is not applicable to or profitable for every entity, it might be worthwhile to check what an AEO-certificate can mean to one’s own organisation. To become an AEO, an organisation should satisfy standards and criteria set by the customs agency.

2.3.2. Find information on using AEOs
   ⇒ Organisations can also make use of the services of an Authorised Economic Operator. The organisation should check which service providers are AEO and what it takes to make use of their services.
2.4. **Chinese Industry Information**

2.4.1. **Gain knowledge on the general market of China**

> Before starting to do business in China, it is highly recommendable to gain knowledge on aspects of the market. Because China’s provinces often have their own distinctive market, the organisation should pay attention to both the general market and provincial markets. General market characteristics include the business climate, available regulatory systems and organisations, and other present businesses.

2.4.2. **Gain knowledge on industry characteristics**

> Gather information on what characterises the target industry. Pay attention to industry differences compared to the home country and make yourself familiar with the overseas industry.

2.4.3. **Identify market pitfalls and warning signs**

> Pay attention to, and search for, signs that indicate possible threats to your business plan in China. By identifying potential threats, the organisation can avoid them or, at least already take them into account during the planning stage.

2.4.4. **Make a market/industry prognosis**

> Plan ahead based on how the organisation thinks the market and industry might develop. Determine the strengths, weaknesses, opportunities, and threats of the market/industry in order to formulate potential scenarios.

2.4.5. **Make a competitor analysis**

> As part of the organisational planning, assess who the competitors are and what the organisation’s position should be in light of these competitors. What effect will outsourcing have on the organisation’s competitiveness?
2.4.6. **Assess the political situation and possible consequences**

→ Try to complement a business perspective with a political perspective in order to come up with a broad assessment of the external environment of the organisation. To what extent is the (provincial) government stable enough to guarantee a prosperous business?

2.4.7. **Assess risk of exchange-rate policy**

→ In light of the state-controlled Chinese monetary policy, with the Renminbi partly pegged to the US dollar, organisations should take into account fluctuations of the currency and its effect on business practice. The slowly, yet continuing appreciation of the Chinese yuan, will make import from China more expensive.

### 2.5. **Chinese Provincial Market Information**

2.5.1. **Find information on specific products**

→ Chinese provinces accommodate distinctive industries. Organisations with an outsourcing initiative should conduct research on particular products (processes) they want to outsource.

2.5.2. **Find information on local government**

→ Because Chinese provinces have local governments that often have their distinctive policies, organisations should investigate how specific provincial policies affect their planned operations. Take into account that several Chinese provinces have the status of a ‘Special Economic Zone’ (SEZ), which provides considerable trade advantages.

2.5.3. **Find information on taxes**

→ In accordance with different provincial governments and their respective policies, organisations should know what taxes apply in specific provinces.

2.5.4. **Find information on trade regulations**

→ In accordance with different provincial governments and their respective policies, organisations should know what trade regulations are in place in specific provinces.
2.5.5. **Find information on non-tariff barriers (NTBs)**

→ *In accordance with different provincial governments and their respective policies, organisations should know what non-tariff barriers are in place in specific provinces.*

2.5.6. **Find information on property rights**

→ *In accordance with different provincial governments and their respective policies, organisations should know what property rights can be enforced in specific provinces.*

2.5.7. **Find information on harbour/customs processes**

→ *Organisations should gather insight into how harbours and customs operate in specific provinces.*

2.5.8. **Find information on local transport possibilities**

→ *Organisations should gather insight into both the infrastructure within a province and intra-provincial infrastructure.*

2.6. **Dutch Market Information**

2.6.1. **Find information on import tariffs for specific products**

→ *When importing products to the Netherlands, organisations should gather information on the import tariffs for specific products. By means of a product code these tariffs can be found on the website of the Dutch customs.*

2.6.2. **Find information on import regulations for specific product categories**

→ *There are distinctive import regulations for specific product categories. Before deciding to import a product, the organisation should find out what regulations apply for the specific product. An example would be that products for consumption differ in terms of regulations from non-consumption products.*

2.6.3. **Find information on quality criteria**

→ *The European Union has quality standards for the majority of products that enter the European community. Before importing products, the organisation should assess what quality criteria are in place.*
2.6.4. **Find information on value-added taxes**

→ *What value-added taxes can you expect when importing your product to the Netherlands?*

### 2.7. **Transport Information**

2.7.1. **Find information on local transport in China**

→ *This transaction cost refers to the transport from your supplier(s) to the harbour. Gather information on what transport possibilities the region in which you do business boasts.*

2.7.2. **Find information on local transport in the Netherlands**

→ *Find modes of transport and service providers for the cargo that has been delivered in the Dutch harbour. Often, shipment goes on to warehouses or directly to the client.*

2.7.3. **Find information on intercontinental transport**

→ *Find the modes of transport and the service providers for overseas cargo.*

2.7.4. **Find information on inco-terms**

→ *Inco-terms are international sales terms published by the International Chamber of Commerce and are agreed upon by governments, legal authorities, and traders, for the purpose of international trade. Inco-terms establish the responsibilities of the buyers and sellers.*

2.7.5. **Find information on container loads**

→ *A container can be a ‘full load container’ (FLC) or a ‘less than container load’ (LCL). FLC refers to a standard container that is fully loaded with goods of a single consignee. FLC enjoy the advantage of lower freight rates compared to an equivalent weight of cargo bulk. A LCL often implies that the cargo has multiple consignees, who share a container. Depending on the volume and weight of the cargo, the organisation should determine whether to make use of FLC or LCL.*
2.7.6. **Conduct a cost-benefit analysis of modes of transport**

→ *Make an analysis of the possibilities for modes of transport. Analyse the efficiency of different modes of transport based on variables such as costs, delivery times, and available infrastructure.*

2.8. **Local Culture Information**

2.8.1. **Find information on informal practices**

→ *The informal practices in China differ from what is common in the Netherlands. One should think of the manner in which relationships are established and maintained, the gifts, and other implicit cultural understandings.*

2.8.2. **Find information on business culture**

→ *What goes for informal practices also applies to the Chinese business culture. Notable differences include the importance of informal gatherings such as dinners, the communitarian values, and long-term perspective on relationships.*

2.8.3. **Find information on language-barriers**

→ *Chinese holds many different dialects that are inherently different from each other. Therefore, the organisation should consider which dialects it will encounter in the outsourcing process and the possible language barrier that has to be dealt with.*
3. Vendor Assessment

3.1. Background Preparation

3.1.1. Specify products

→ The organisation should carefully specify what kind of product it wants to import and determine the related requirements regarding the product’s design and quality. It is of utmost importance to leave vendors out of this process. Preferably the organisation does not even have contact with vendors yet in this stage of the process. Vendors can directly or indirectly influence your idea of what you want them to deliver.

3.1.2. Put in place a vendor evaluation team

→ When the organisation is sufficiently large, it should put in place a vendor evaluation team. This team represents the company during the importing/outsourcing initiative and should comprise of staff with a cross-functional background. The tasks of the evaluation team entail establishing an evaluation process, as well as vendor inventory and selection.

3.1.3. Check for legal stipulations regarding a vendor evaluation process

→ For some organisations, especially governmental organisations, it is required to have a fair evaluation vendor selection process. This selection process can be subject to an audit. It is therefore important to check possible legal stipulations before putting in place an evaluation process.

3.1.4. Put in place a well-defined vendor evaluation process

→ The organisation should establish a standardised, fair and documented evaluation process. Having a proper vendor evaluation process ensures the selection of high-quality vendors.
3.2. **Manageable List of Vendors**

3.2.1. Visit trade fairs
   → Potential vendors can be found on trade fairs, both in China and in other parts of the world, including the Netherlands.

3.2.2. Create a list of possible suppliers from different sources
   → Potential vendors should be placed on a list for further comparison and analysis. It is advisable to have multiple sources for the vendor search. This way, organisations have a better guarantee of listing a diversified portfolio of possible suppliers.

3.2.3. Request additional vendor information
   → Request more information on the short-listed vendors to gain greater insight into their capabilities and qualifications.

3.2.4. Wait for vendors’ responses
   → Wait for the vendors to have supplied the organisation with the requested information.

3.3. **Vendor Evaluation**

3.3.1. Check location of vendors
   → The location is an important factor in considering different vendors. Based on previously discussed information search costs, assess how the vendors’ location can affect the way of doing business (e.g. governmental regulations, competition, infrastructure, etc.)

3.3.2. Check the experience of vendors
   → Determine how experienced the potential vendors are. Experience can reveal the ease of doing business (relatively new vendors might not have the know-how of more experienced vendors) and it may also give an indication of the quality-level of product- and service provision.

3.3.3. Check financial robustness of vendors
   → Check the financial robustness to assess the likelihood of ‘unforeseen’ defaults or other operational disturbances.
3.3.4. Check reputation/customer satisfaction of vendors
   → The reputation of the vendor shows how other clients regard this vendor and gives a good indication of the reliability and quality-level of the specific vendor.

3.3.5. Look at the capabilities and strengths of vendors
   → Make an assessment of what the (differences in) capabilities and strengths are of the potential vendors.

3.4. Evaluate vendor proposals

3.4.1. Request offers
   → Request offers from final candidates of the list of potential vendors.

3.4.2. Wait for vendors’ responses
   → The time that elapses between the vendor offer request and the receipt of the offer.

3.4.3. Benchmark vendor offers
   → Benchmark received offers based on previously discussed evaluative characteristics and industry averages.

3.4.4. Evaluate vendors’ understanding of needs
   → Does the vendor truly understand what your business needs are in terms of products, service, and strategy?

3.4.5. Make a risk assessment of vendors
   → What risks are involved in choosing a particular vendor? This should be a risk assessment of evaluative characteristics assessed earlier in the process.
3.5. **In-depth vendor assessment**

3.5.1. **Check sources of vendors**

→ Though a difficult task, it might be insightful to identify the suppliers of potential vendors. The identification of these suppliers gives the organisation insight into their (operational) standards and how these suppliers can indirectly affect the business (e.g. child labour, environmental concerns, etc.).

3.5.2. **Request sample products**

→ Sample products give an indication of whether the organization’s criteria of the particular product can be met in terms of design, quality and the logistical process.

3.5.3. **Evaluate sample products**

→ Evaluate whether the sample products satisfy organisational demands.

3.5.4. **Determine vendors’ cultural fit**

→ The (business) culture of the organisation’s Chinese vendor is likely to be very different from the organisation’s culture. Assess how this fit will impact your business.

3.5.5. **Check whether vendors also provide services to competitors**

→ It might be disadvantageous if your vendor also provides to your competitors.

3.5.6. **Make a cost-benefit analysis**

→ Make an overall cost-benefit analysis based on all the previously discussed evaluative characteristics.
### 3.6. Vendor Visit

3.6.1. **Cost of preparation trip**
   - Costs of preparation to make the trip as efficient and effective as possible: arrangement of contacts, transport etc.

3.6.2. **Apply for visa**
   - The time it takes to apply for a visa and visa possession.

3.6.3. **Costs of visa**
   - The cost of a Chinese visa.

3.6.4. **Transport costs**
   - Transport costs include the airplane tickets to China as well as other transport (e.g. intra-city, inter-city/provincial).

3.6.5. **Accommodation costs**
   - Cost of accommodation.

3.6.6. **Living costs**
   - Living costs include daily needs such as food, drinks,

3.6.7. **Duration of trip**
   - The indirect costs as a result of spending time in China.

3.6.8. **Risks of small/ daily hazards**
   - Costs due to daily hazards commonly include delays in meetings, but also physical problems as a result of the difference in nutrition.

### 3.7. Vendor approval

3.7.1. **Select vendor**
   - After the supplier visits and analysis of suppliers’ evaluative characteristics, it is time to select a vendor.

3.7.2. **Communicate selection to vendor**
   - The time it costs to communicate and confirm the vendor selection, including the risk that the offer is expired.
4. Assessment of Other Service Providers

4.1. Transporters

4.1.1. Specify transport need

→ Determine the best modes of transport, taking into account cargo characteristics and requirements such as weight, volume, distance, and type of packaging.

4.1.2. Create a list of possible transporters

→ Create a list of transporters that will form the basis for your selection, based on specific modes of transport, specified province, etc.

4.1.3. Request additional information

→ Request more information on the transporters of the list in order to get a better insight into their capabilities and qualifications.

4.1.4. Wait for responses

→ Wait for the transporters to have supplied your organisation with the requested information.

4.1.5. Check transporters’ financial robustness

→ Check the financial robustness to assess the likelihood of ‘unforeseen’ defaults or other operational disturbances.

4.1.6. Check transporters’ reputation/customer satisfaction

→ The reputation of the vendor shows how other clients regard this vendor and gives a good indication of the reliability and quality-level of the specific vendor.

4.1.7. Make a risk assessment of transporters

→ What risks are involved in choosing a particular transporter? This should be a risk assessment of evaluative characteristics assessed earlier in the process.

4.1.8. Cost-benefit analysis of transporters

→ Make an overall cost-benefit analysis based on all the previously discussed evaluative characteristics.
4.1.9. Request offers
   → Request offers from final candidates of the list of potential transporters.

4.1.10. Wait for transporters’ responses
   → The time that elapses between the transporter offer request and the receipt of the offer.

4.1.11. Benchmark transporters’ offers
   → Benchmark received offers based on previously discussed evaluative characteristics and with industry averages.

4.1.12. Select transporters
   → Based on the variety offers and the organisation’s criteria and benchmark, select the transporter that is optimal for the outsourcing initiative.

4.1.13. Communicate selection to transporter
   → The time it costs to communicate and confirm the transporter selection.

4.2. Legal Service Providers

4.2.1. Request offers legal service providers
   → In case the organisation decides to make use of legal service providers, an inquiry has to be made into the costs of this service by means of an offer.

4.2.2. Evaluate offers legal service providers
   → It takes time to assess the offer and make a trade-off between making use of the service and not making use of the service.

4.2.3. Select legal service provider
   → Based on the variety offers and the organisation’s decision with regard to the trade-off, select the legal service provider that is optimal for the outsourcing initiative.

4.2.4. Costs of legal service provider
   → The actual cost of the provided service.
4.3. **Due Diligence Agents**

4.3.1. **Request offers due diligence agents**

→ *In case the organisation decides to make use of due diligent agents, an inquiry has to be made into the costs of this service by means of an offer.*

4.3.2. **Evaluate offers due diligence agents**

→ *It takes time to assess the offer and make a trade-off between making use of the service and not making use of the service.*

4.3.3. **Select due diligence agent**

→ *Based on the variety offers and the organisation’s decision with regard to the trade-off, select the due diligence agent that is optimal for the outsourcing initiative.*

4.3.4. **Costs of due diligence agent**

→ *The actual cost of the provided service.*

4.4. **Translators**

4.4.1. **Request offers translators**

→ *In case the organisation decides to make use of due translators, an inquiry has to be made into the costs of this service by means of an offer.*

4.4.2. **Evaluate offers translators**

→ *It takes time to assess the offer and make a trade-off between making use of the service and not making use of the service.*

4.4.3. **Select translator**

→ *Based on the variety offers and the organisation’s decision with regard to the trade-off, select the translator that is optimal for the outsourcing initiative.*

4.4.4. **Costs of translator**

→ *The actual cost of the provided service.*
4.5. Advisors

4.5.1. Request offers advisors
→ *In case the organisation decides to make use of advisors, an inquiry has to be made into the costs of this service by means of an offer.*

4.5.2. Evaluate offers advisors
→ *It takes time to assess the offer and make a trade-off between making use of the service and not making use of the service.*

4.5.3. Select advisor
→ *Based on the variety offers and the organisation’s decision with regard to the trade-off, select the advisor that is optimal for the outsourcing initiative.*

4.5.4. Costs of advisor
→ *The actual cost of the provided service.*

4.6. Business representatives

4.6.1. Request offers business representatives
→ *In case the organisation decides to make use of business representatives, an inquiry has to be made into the costs of this service by means of an offer.*

4.6.2. Evaluate offers business representatives
→ *It takes time to assess the offer and make a trade-off between making use of the service and not making use of the service.*

4.6.3. Select business representative
→ *Based on the variety offers and the organisation’s decision with regard to the trade-off, select the business representative that is optimal for the outsourcing initiative.*

4.6.4. Costs of business representative
→ *The actual cost of the provided service.*
4.7. **Handling agents**

4.7.1. Request offers handling agents

→ In case the organisation decides to make use of handling agents, an inquiry has to be made into the costs of this service by means of an offer.

4.7.2. Evaluate offers handling agents

→ It takes time to assess the offer and make a trade-off between making use of the service and not making use of the service.

4.7.3. Select handling agent

→ Based on the variety offers and the organisation’s decision with regard to the trade-off, select the handling agent that is optimal for the outsourcing initiative.

4.7.4. Costs of handling agent

→ The actual cost of the provided service.

4.8. **Quality inspectors**

4.8.1. Request offers quality inspectors

→ In case the organisation decides to make use of quality inspectors, an inquiry has to be made into the costs of this service by means of an offer.

4.8.2. Evaluate offers quality inspectors

→ It takes time to assess the offer and make a trade-off between making use of the service and not making use of the service.

4.8.3. Select quality inspector

→ Based on the variety offers and the organisation’s decision with regard to the trade-off, select the quality inspector that is optimal for the outsourcing initiative.

4.8.4. Costs of quality inspector

→ The actual cost of the provided service.
4.9. **Insurers**

4.9.1. **Request offers insurers**
→ *In case the organisation decides to make use of insurers, an inquiry has to be made into the costs of this service by means of an offer.*

4.9.2. **Evaluate offers insurers**
→ *It takes time to assess the offer and make a trade-off between making use of the service and not making use of the service.*

4.9.3. **Select insurer**
→ *Based on the variety offers and the organisation’s decision with regard to the trade-off, select the insurer that is optimal for the outsourcing initiative.*

4.9.4. **Costs of insurer**
→ *The actual cost of the provided service.*

4.10. **Accountants**

4.10.1. **Request offers accountants**
→ *In case the organisation decides to make use of accountants, an inquiry has to be made into the costs of this service by means of an offer.*

4.10.2. **Evaluate offers accountants**
→ *It takes time to assess the offer and make a trade-off between making use of the service and not making use of the service.*

4.10.3. **Select accountant**
→ *Based on the variety offers and the organisation’s decision with regard to the trade-off, select the accountant that is optimal for the outsourcing initiative.*

4.10.4. **Costs of accountant**
→ *The actual cost of the provided service.*
4.11. Government Involvement

4.11.1. Information on government involvement

→ The Chinese government has much control over many business aspects in China. Although this influence has decreased somewhat over the past years (foreign investment rules may change yearly), it remains important to find out to what extent the government can and will influence the outsourcing process.

4.11.2. Assess need for government involvement

→ As local governments have a certain freedom in denying proposed projects, withdrawing licenses etc. it is advisable to look at the trade-off between involving the (local) government and not doing so.

4.11.3. Contact government

→ In case the decision is to involve (local) government, time and money has to be spent on meeting with the officials.

4.11.4. Negotiate with government

→ It may be the case that the organisation has to negotiate with government officials about aspects of the business process.

Engagement

5. Contract and Negotiation Management

5.1. Describe components of the contract

5.1.1. Describe the scope and nature of the engagement

→ Before thinking about actual clauses and contract components, the organisation ought to identify what the engagement will entail: What type of relationship is involved? Who are the actors?

5.1.2. Describe the roles and responsibilities of the client organisation

→ The organisation will want to make explicit what its role and responsibilities will be in the business engagement.
5.1.3. Describe the roles and responsibilities of the vendor organisation
   → Just as the client organisation should describe its own role and responsibilities, it should also assign the role and responsibilities of the business partner.

5.1.4. Describe the metrics for evaluating the performance of the relationship
   → An important aspect that has to be configured before entering relationship is the way performance is evaluated. What key indicators will be used? How will these indicators be measured? When will these indicators be measured?

5.1.5. Describe recourses in case things do not go as expected
   → In the contract, a component should be dedicated to recourses. Situations that ask for recourses include a service provider that does not comply with the terms of the contract.

5.2. Contract formulation

5.2.1. Search for model vendor contract
   → If the organisation wishes to form a contract with a vendor, one of the initial actions is to find models contracts. A model contract provides insight into what aspects will have to be considered when drafting a contract.

5.2.2. Search for model transporter contract
   → The same holds for a contract with transporters: what does a contract look like for the different modes of transport? What are importing clauses to include in a contract? Model contracts can partly answer these questions.

5.2.3. Research contract establishment procedures
   → The second step is to find out what the contract establishment procedures entail: Whom do I contact? Do I need to make a preliminary draft? What are China specific aspects (if I choose to use a contract in China, will it be different from other contracts)? Will I need to use international law, Chinese law, etc? After this stage, the process of drafting a contract should be clear.
5.2.4. **Contact legal service providers**

In most cases, a third party will be involved in drafting a contract. Some organisations prefer to use large, established institutions with international presence since these firms have much knowledge of local culture and law. Others may prefer smaller, local service providers.

5.2.5. **Meet with legal service providers**

It will most likely take several meetings with the legal service provider to be able to draft a comprehensive contract (for as far this is desired).

5.2.6. **Define content criteria**

The organisation should think about, and define, importing criteria such as the output level, quality level, duration of supply, warranty, packaging, ownership retention, force majeur, distribution arrangements (exclusive buyer), legal responsibility, applicable law, arbitrage (dispute settlement), inco-terms, patent protection, a list of foreseeable events, terms of the contract, method of payment, and enforcement possibilities among others.

5.2.7. **Make a list of contingencies**

It may be useful before negotiations start, to make a list of contingency factors that may go wrong. This way, it becomes clear what aspects should be focused on in negotiations.

5.2.8. **Prioritise contract needs**

A list of priorities will allow for more clarity on which aspects are most important, and which factors (of for instance the before mentioned contingencies) are of less concern.

5.2.9. **Take into account vendor needs**

It is important to make an analysis, before the negotiations, of what the most likely needs of the vendor are. The negotiations are likely to be smooth when there is awareness of one another’s points of concern.
5.2.10. Wait for preliminary contracts
\(\rightarrow\) The preliminary versions of the contracts before the negotiations take time to draft.

5.2.11. Contact business representative
\(\rightarrow\) In most cases, a business representative with knowledge of the culture, the local businesses, the language, and negotiation techniques is desirable.

5.2.12. Contact negotiator
\(\rightarrow\) An alternative is to hire a skilled negotiator exclusively for the process of negotiation and drafting the contract.

5.2.13. Contact translator
\(\rightarrow\) If the organisation would decide to do the negotiations without external representatives or negotiators, and there exists a language barrier, a minimum requirement is the hiring of a translator who can be present during negotiations.

5.2.14. Gather information on Chinese contract negotiation
\(\rightarrow\) Also, if the organisation is to negotiate with a vendor (or transporter) without the help of an external party, it is advisable that considerable time is spent on studying important Chinese negotiation techniques and customs.

5.2.15. Contract formation
\(\rightarrow\) The actual formation of the contract is an obvious transaction cost in terms of time.

5.2.16. Create a backup plan for contract formation failure
\(\rightarrow\) It is important in the process to be aware of the fact that the contract formation may fail: either due to a gap in needs and desires of the parties, or due to problems in the relationship. The outsourcing organisation should have a backup plan (e.g. an alternative vendor).
5.2.17. **Miscommunication during negotiations**

→ In communicating with organisations from other cultures, such as Chinese organisations, it is not unlikely that miscommunications may occur, even with a more experienced third party involved. The effects of this miscommunication need not always be devastating, but delays should not be ruled out.

5.2.18. **Formulate an exit strategy**

→ From the start of the contract negotiations, the organisation should think about what to do if one of the parties decides to end the relationship.

### 6. Logistics

#### 6.1. Logistical Risks

6.1.1. **Delays in production**

→ Any delays in the production process may be a costly matter. Possible delays in the production process may for example be the result of less trustworthy equipment or inferior security measures in factories.

6.1.2. **Delays in meetings**

→ Throughout the logistics process, the organisation should not underestimate the difficulty of arranging meetings. Especially in a country like China, in which the importance of a face-to-face meeting is considerable, there is much room for delays.

6.1.3. **Delays in transport**

→ In transport, delays can also occur. One can think of delays in on- and off-loading and delays in shipping due to, for example, bad weather.
6.1.4. **Delays at customs**
   → Time at customs varies. It can partly be influenced by the shipping company if cargo scans are arranged in a timely fashion. Other aspects such as downtime of the (scanning) machinery cannot be hedged.

6.1.5. **Meet with financial expert for hedging currency risk, and payment method**
   → Time and money can be invested in getting expert advice on currency risks. The organisation does not want to be exposed to too much currency risk as this may have negative income effects. The matter of payment method should also be clear for both parties involved.

6.1.6. **Meet with insurance expert**
   → Similar to the currency risk, certain insurance issues have to be considered. Possible areas for insurance include distribution complications and transport risks.

6.1.7. **Erroneous production orders**
   → There is always a risk that there is an erroneous production order for which the outsourcing organisation is responsible. This risk may be greater after new a new product introduction or with more customised products, but it is certainly a risk that should be accounted for.

6.1.8. **Deal with corruption**
   → Corruption may be an issue in China and it can take many forms. The organisation may be forced to incorporate a government official in the business process, or a local quality inspector may do its job less thorough for a payment. These two examples make it clear that the outsourcing organisation may have to include transaction costs for corruption.
6.1.9. Repair products due to damages
→ During the process of outsourcing, the products may be damaged, especially during the different handling points (at the vendor’s premises, at the Chinese harbour, at the Dutch harbour, or at different distribution points). In case the products can be repaired, the defined (or undefined) responsibilities of the parties involved should determine who pays for the repairs.

6.1.10. Delay due to product damages
→ Either having to wait for the repairs or having to wait for a whole new shipment of products, both cause a delay in the process.

6.1.11. Delay due to lost products
→ If products get lost for whatever reason, a delay is likely to occur in the process.

6.2. Negative Quality Controls
6.2.1. Sunk cost of relationships
→ In case the quality of the products is not up to the standards, harm can be done to the relationship (for example if the vendor claims that the quality is conform specifications). In an extreme situation, the relationship investments made in the past are undone and should be considered a sunk cost.

6.2.2. Rebuilding relationships
→ It takes time and money to rebuild a stressed relationship.

6.2.3. Formulate feedback for vendor
→ If the quality of the products is not satisfactory, clear feedback should be formulated for the vendor. In some cases it may be necessary to actually visit China, for one because this is much appreciated by the Chinese business partner. In addition, quality problems might require structural changes to the production process that are not easy detected or communicated via e-mail or telephone.
6.2.4. **Wait for revised products**

→ *As a result of possible disposable products, the outsourcing organisation has to wait for a new (and revised) batch of products.*

6.2.5. **Storage in the Netherlands**

→ *Once quality control in the Netherlands (by Dutch customs, or the ‘Voedsel Waren Autoriteit’ (VWA), for example) has a negative result, the products may have to be stored before disposal. The costs of this storage may be assigned to the vendor or the outsourcing organisation, depending on the responsibility for the quality problem (this may be due to the production process or due to wrong specifications by the outsourcing firm).*

6.2.6. **Product disposal**

→ *The products that cannot be used for consumption will have to be disposed of. This disposal can again be paid for by the vendor or by the outsourcing organisation.*

6.3. **Logistics China**

6.3.1. **Place product order**

→ *Starting the actual outsourcing process begins with an order. This can be a smooth process but one should not rule out miscommunication and misunderstanding.*

6.3.2. **Specify quality needs to quality inspector**

→ *If the product is to be checked before leaving China (preferably on the premises of the vendor), the outsourcing organisation should communicate the quality needs and criteria to the inspection service provider (that was chosen earlier in the process).*

6.3.3. **Notify vendors of inspection**

→ *The vendors should be made aware of the quality inspection, in the first place with respect to the relationship with the Chinese vendor, but also so that no misunderstanding occurs (and the goods are already transported elsewhere).*
6.3.4. Wait for confirmation of order
   → It is only when the order placement is confirmed that one is informed when the actual production starts.

6.3.5. Wait for inspection results
   → Before being able to transport the goods, the organisation has to wait for the inspection service provider to share the results of the inspection.

6.3.6. Review results of quality check
   → The results of the quality inspection have to be reviewed.

6.3.7. Notify transporter
   → The transporter should be made aware of the fact that the cargo can be picked up from the vendor’s premises. Depending on the inco-terms, either the vendor makes this notification, or the outsourcing firm (or its business representative) does so.

6.3.8. Wait for the products
   → This entails nothing more than the production waiting time without any potential delays.

6.3.9. Package the products
   → The packaging of the products is a transaction cost that differs in significance. It can be done by the vendor or externally, based on the packaging criteria as well as the skills and abilities of the parties involved.

6.3.10. Transport products to warehouse
   → In case direct shipment is not possible, the goods will first have to be transported to a warehouse.

6.3.11. Transport products to harbour
   → Either from the vendor’s premises or from the warehouse, the goods can be shipped to the harbour of choice in China.

6.3.12. Apply for export clearance
   → Before the organisation is able to ship the products, an export clearance has to be obtained.
6.3.13. Handling costs Chinese harbour

→ Any handling costs in the Chinese harbour depend on the inco-terms.

6.3.14. Loading products onto ship

→ Loading the container(s) on board will be a cost either incurred by the vendor or the by outsourcing firm, based on the inco-terms.

6.4. International logistics

6.4.1. Deal with transport documentation process

→ Having the right transport documents in order (bill of loading) and paying the needed instalment are costs incurred in the process of logistics. These costs are charged by the handling agent.

6.4.2. Transport waiting time

→ This transaction cost is merely the expected transport time without any potential delays.

6.4.3. Fill in electronic pre-arrival cargo declaration

→ 72 hours before arrival in the harbour, the shipping company should fill in and send an electronic notification of the arrival of the cargo.

6.4.4. Notify customs and VWA (Voedsel Waren Autoriteit)

→ Upon arrival, a declaration has to be filled in for both the Dutch customs and possibly the VWA.
6.5. **Logistics Netherlands**

6.5.1. **Offloading products Dutch harbour**

→ *Once the cargo has arrived in the Dutch harbour (most likely Rotterdam), the products (in a container) will be offloaded onto shore and the costs will be translated into handling agents’ fee.*

6.5.2. **Wait until the products reach the checkpoint**

→ *In case the risk profile made by the Dutch customs has indicated that the organisation’s container(s) will have to go through a scan, the container(s) are transported to a checkpoint. Approximately 5% of all containers entering the harbour in Rotterdam are checked. The total waiting time and time needed for the scan can be up to 3 days.*

6.5.3. **Cargo check**

→ *The cargo check can be performed either by a scan, by unpacking products, by means of dogs, or by a combination of these options. The waiting time differs depending on the method of checking the cargo. Dutch customs claim that all containers can be checked within 72 hours.*

6.5.4. **Degassing**

→ *Most containers from China have to be degassed in order to decrease the risk of any harmful insects entering the European Union. This degassing takes time since the container will have to be transported to a degassing point (controlled by a third party), and thereafter back to the checkpoint of the Dutch customs. This process may take a day to a week, with an average processing time of 1 to 2 days.*

6.5.5. **Demurrage in harbour**

→ *If, for whatever reason, the cargo has to stay in the harbour, the organisation pays demurrage costs depending on the duration of the storage.*

6.5.6. **Transhipment to warehouse**

→ *After all cargo has been cleared, it can be transported to the warehouse or distribution centres.*
Process
7. Relationship Management

7.1. Cross Cultural Issues

7.1.1. Strained relations due to cultural misunderstanding

→ Multiple misunderstandings as a result of cultural differences may occur when working together with Chinese vendors and other third parties. This can lead to strained relationships, which may provide the basis for opportunistic behaviour (e.g. unrightfully selling to the product to other organisations).

7.1.2. Limited knowledge sharing due to cultural misunderstanding

→ Limited knowledge sharing may be the result of not respecting cultural differences. Chinese vendors may be prone to share only the essential information (or even less) when foreign organisations do not conform to certain customs. An example would be that an organisation simply needs to invest time in the relationship to make it work. Without this significant investment, Chinese business partners are likely to be hesitant to share knowledge and development, and cooperate.

7.1.3. Building guanxi

→ An important aspect in doing business in China is guanxi, or relationships. Relationships are important for doing business in China as it presents a way to deal with risks: the better the relationship, the smaller the chance of opportunistic behaviour will be. Where in western countries law is seen as an essential feature to conduct business, in China this idea is less prominent (law enforcement is therefore more difficult) as the focus is more on social pressure to ensure compliance with (business) arrangements. For the outsourcing organisation it is important to recognise this need for relationship building. Of course, the degree and intensity of relationships may differ but almost without fail, a simple contract will not suffice. Bear in
mind that building real guanxi will take years and that using third parties that are already established in China may be important.

7.1.4. Building reputation (mianzi)

Related to the before mentioned guanxi, mianzi also plays an essential role in China. Where guanxi represents the relationships, mianzi represents the recognition of a good (moral) reputation. Mianzi can best be translated as ‘face’ and entails the need to build a certain reputation (prestige) through successes. Hence, it takes time and effort to build mianzi, but once established, it will provide the organisation with the necessary prestige to smoothen business conduct.

7.1.5. Cost of losing face

→ There may be ramifications when the organisation loses mianzi: the party that loses face may be considered unworthy of doing business with. The result can therefore be stressed business relationships and reduced business opportunities.

7.1.6. Investments in relationships

→ Through partly related to guanxi, this transaction cost should be considered in a more general sense: on the one hand creating guanxi may call for relationship- investments as a result of reciprocity (you may need to provide favours to third parties in order to create a longer-term commitment). On the other hand, the organisation may need to make investments in relationships with third parties as well (business representatives, handling agents, etc.).

7.1.7. Relationship-related visits

→ One of the key aspects of doing business with China is the need to go there. Not just at the start of the project, but on a regular basis. The longer the organisation knows and meets with business partners, the better the relationship and hence the business will be.
8. Continuance-, Modification-, and Exit Strategies

8.1. Evaluate Internal Events

8.1.1. Evaluate product quality

→ The first consideration is whether the product produced by the vendor is still of the specified quality.

8.1.2. Evaluate future product needs

→ The product needs of the outsourcing organisation may change over time. Future developments in quantity, quality, extensions, product lines, among others, should be considered in order to answer the question whether the vendor is flexible enough to cope with changes in needs.

8.1.3. Evaluate financial situation

→ The financial situation of the organisation should not be disregarded. The actual costs of outsourcing (hard- and soft transaction costs as well as production costs) should be considered. A clear picture of these costs may provide greater insight into where transaction costs can be eliminated. Other outsourcing locations may be evaluated as a result.

8.1.4. Evaluate stakeholder expectations

→ Different stakeholders of the outsourcing organisation may have differing demands and expectations as to the activities and performance of the organisation. Developments of these demands expectations should be monitored (product demands of customers, governmental criteria for import, price demands of distribution offices, etc.).
8.2. **Evaluate External Events**

8.2.1. **Evaluate political situation**

→ The political environment may be an important source of change in import viability. With regard to China, changes in government involvement can present new opportunities or threats. Compliance to government regulations may be an expensive matter for the vendor, the costs of which could be presented to the outsourcing organisation.

8.2.2. **Evaluate currency development**

→ The organisation should be aware of any currency changes (such as the loosening of the fixed rate of the Renminbi, pegged to the US dollar). Appreciation of the yuan increases the price of importing from China.

8.2.3. **Evaluate economic changes in the outsourcing location**

→ Economic changes in the outsourcing location may include changes in labour costs, changes in transport costs, or other alterations that can impact the import process.

8.3. **Evaluate Vendor’s Business**

8.3.1. **Evaluate inter-organisational communication**

→ In the evaluation of the vendor’s business, it might be important to consider how inter-organisational communication between the vendor and the outsourcers functions. Miscommunications and delays should be taken into account.

8.3.2. **Evaluate financial and market viability**

*Although information on this aspect may be hard to obtain, monitoring the financial situation (and hence the stability) of the vendor is important. The same holds for the market viability: does the vendor’s business appear to be competitive?*
8.3.3. **Evaluate contract compliance**

→ *It should be evaluated whether the vendor lives up to the contract agreements or whether contract breaches have occurred. In case of a non-contract business agreement, the vendor can be evaluated in terms of its compliance with agreed upon aspects of doing business.*

8.3.4. **Evaluate vendor’s management**

*The outsourcing business ought to be aware of changes in management and the potential consequences on the vendor’s business and its relationship with the outsourcing organisation.*

8.3.5. **Evaluate vendor’s relationships**

→ *Any changes in the network of third parties that the vendor makes use of should ideally be the concern of the outsourcing firm. Negative surprises can be hedged in this manner.*

8.3.6. **Evaluate vendor’s regulatory compliance**

→ *Important for the reputation and ethical considerations of the outsourcing business is whether the vendor still performs its activities within legal boundaries.*

**8.4. Modifications**

8.4.1. **Define new product/ process requirements due to changes in needs**

*For a modification in the imported product or the outsource process, it should first be made clear what the revised needs are in terms of new requirements (e.g. draw the new product, formulate new product requirements).*

8.4.2. **Formulate/ communicate feedback in accordance with new needs**

*As a result of any of the before mentioned changes in needs, feedback has to be formulated for the third party or other stakeholders, which should subsequently be communicated.*

8.4.3. **Renegotiations**

*Time and money may have to be spent on renegotiating the contract, or non-contract business agreement, if the importer wishes to modify the initial agreement.*
8.4.4. **Redrafting the contract**  
*In case of a modification in the importing process, the initial contract will have to be redrafted to represent the current situation. This only applies in a business agreement that is based on a contract.*

8.4.5. **Higher prices for offering**  
*When a contract or non-contract business agreement needs to be revised, there is a chance that the vendor or other third party requires a higher price.*

8.5. **Exits**

8.5.1. **Procurement disruptions**  
*In case of terminating the business relationship with the vendor(s), the outsourcing firm should be aware of procurement disruptions (e.g. not being able to deliver products to distribution offices in a timely fashion).*

8.5.2. **Revise exit strategy during outsourcing lifecycle**  
*As new information becomes available on internal events (within the outsourcing firm), external events (the outsourcing environment, e.g. policy developments in China), or the vendor’s business, the exit strategy may have to be revised. This is a continuous process.*

8.5.3. **Contract termination ramifications**  
*In case a contract is terminated with a third party, there may be financial ramifications depending on the termination clauses in the contract.*
5. Discussion

In the previous section, a list of transaction costs was presented. This list is theoretical in the sense that practice often diverges. In the following part the most important divergences will be discussed. The part thereafter attempts to highlight some developments in the context of outsourcing to China which practitioners may encounter.

5.1 Theory and Practice: Discrepancies

In the previous section the list of transaction costs was specified. As was mentioned, this list is a list of potential transaction costs. Hence, each of the transaction costs can be encountered in practice. Depending on the type of business, the type of product, the decisions made by the organization and other contingency factors, some costs will be relevant to a greater extent than other costs, whereas other transaction costs may not be encountered at all.

This section will present some situations and scenarios encountered in practice that diverge from the theoretical list of transaction costs discussed previously. The scenarios are based on a select number of interviews with organizations/entrepreneurs and specialists involved in outsourcing. It is important to note that these are merely the result of a small number of interviews and thus provides a indication of discrepancies between theory and practice and the implications of these discrepancies. It is not meant to be collectively exhaustive.

Each of the discrepancies are discussed next. For each of these discrepancies a number of possible (cost) implications can arise. For this reason, the change in the transaction costs which arise as a result of these divergences will be mentioned.
- **Third Parties**

The first important factor that can influence the transaction costs of an outsourcing initiative is the use of third parties. In the transaction cost list, a large number of potential third parties were already mentioned. The use of these third parties can increase or decrease the costs made significantly. Some examples:

- Due diligence of vendors can hedge the risk of production defaults, quality difficulties and other vendor-related problems. Hence, in general, performing a thorough due diligence process can decrease the (potential) costs in the categories *logistical risks*, and *negative quality controls*. Before doing business in China, one can decide to make use of an organization that performs a due diligence of each of the potential business partners. Examples are organizations such as Diligence China. By utilizing the knowledge and networks of these types of organizations one can save considerable transaction costs of doing the necessary due diligence oneself. The transaction cost categories of the vendor assessment stage such as *vendor evaluation*, *evaluate vendor proposals*, and *in-depth vendor assessment* can be performed by an organization specialized in due diligence in China. Other categories like *Chinese Market Information* and *Chinese Provincial Market Information* may also be considerably less important if such a party is used. If one chooses not to have the due diligence done by a third party, one should consider if it is possible to achieve the same quality of results. In practice it becomes clear that business representatives are contacted via locally established organizations or organizations with knowledge and relationships in China.

- A third party can also be used for an even larger part of the outsourcing process. In the most extreme case, organizations like Advantage China, can perform practically all parts of the sourcing process: from specifying needs, to negotiations, to quality control and exit strategies. Depending on the fee and quality of these organizations, one can determine the potential benefits of using these third parties. In practice one sees that organizations often want to have more control over the process and decide to either use a third party for part of the process or do as much as possible internally. It can be a missed cost-saving
possibility, however, not to consider the use of third parties: one may have to reinvent the wheel.

- **Product Specifications**

In the transaction list it became clear that considerable time has to be spent on specifying the product and communicating product needs to the vendor(s). In practice we see that this process can not only take much time, it is also sensitive to disruptions. These disruptions may arise when the organization has a certain product in mind and communicates the specifications to the Chinese vendor. We found that when there is something not entirely clear or made explicit, the Chinese vendor may feel the need to use his own creativity. The result was often not desired and new specifications had to be sent. This process might be repeated multiple times until the correct product can be made.

If the products were produced correctly, we found that the product code specification (HS-code) might cause another problem. An incorrect HS code (in the freightletter) can cause unwanted delay.

These two examples show that not spending enough time on specifying the product and communicating product specifications (transaction cost specify product) to the vendor can impact the transaction costs such as logistical delays and relationship investments.

A last matter related to this category of discrepancies has to do with the way firms, engaging in an outsourcing initiative, do about choosing the vendor and product. In much of this report, we have assumed that a certain product, with its related product specifications, exists. Next, we assumed that the organization attempts to find a vendor that can produce the product in the desired manner. In practice, however, we encountered an alternative approach. In this approach, the designer (of an organization that wishes to outsource) took the capabilities of the vendors (which presented themselves at fairs for instance) as a starting point. By seeing what the vendors were capable of producing, or were good at making, the organization invented a product to import, or specified the product needs, in accordance with these capabilities. Obviously, this strategy very much depends on
ones business plan. Potential benefits may be less logistical disruptions and quality problems (and thus transaction costs) because you diverge less from the core competences of the vendors. This does not mean, however, that quality control becomes obsolete.

- **Quality Control**

In practice, we found that not all organizations that have outsourced (part of) their production to China make use of effective quality control mechanisms and organizations. It appears that well-known organizations in the field of quality control (in addition to other services) such as PRO QC International and Asquance, are not always known or are considered too expensive. The alternatives, however, do not always seem more cost-efficient or effective. We encountered organizations that simply check the products back in Holland, where it occurs multiple times that there is a small but essential difference in the design, making the product unsuitable for its purposes. One time, the organization eventually had to send a representative to China to make sure that the product was produced correctly. Not only does this impact the transaction costs of having to travel to China, and does it impact the distribution process (and logistics) because one might not be able to deliver on time, it may also cause relational distress due to a possible lack of trust between the business parties.

An alternative that also occurs in practice, is a quality check coupled to assembly. Not sporadically, products are assembled elsewhere than where the product parts are produced. Some organizations consider it wise to do the quality check at this assembly location. The result is that, for the organization of this example, product parts were produced in China and shipped to eastern Europe, where the quality was checked and the products were assembled.

The implications of this procedure are multiple: obviously, had the product (or rather the product parts) been checked in China, any problems with the quality could have been either revised, or at least noticed sooner. By doing the check in Eastern Europe, potential problems are noticed later and thus it takes longer to ensure that a correct batch of products is delivered to the distribution points. The organization hedges these risks as follows: they simply order far larger amounts
than are needed to fulfill demand for the product. In this way they create a buffer for in case things go wrong, quality-wise.

From this we may draw the conclusion that not checking (or having the checked) the quality in a timely fashion can create serious logistical (distribution) disruptions. It may also be the cause of large stocks, which all have to be paid for, that can not be combined with ambitions like just-in-time delivery, and thus are not cost efficient.

- **Contracts and Relationships**

In the list of transaction costs of the previous section, considerable attention is paid to the formation, negotiation and honouring of contracts. Contracts are often an important factor in doing business since they provide clarity about the roles and responsibilities of the parties, but they also provide a way for each of the business partners to gain insight into one another.

It was already mentioned before, that the Chinese way of doing business is different from a ‘western’ way of doing business, and that this difference should be accounted for. One of these differences that is mentioned often in literature about Chinese business, is the resistance toward contracts. In practice we find that many, if not all, interviewees acknowledge this resistance and argue that it is best not to pursue the formation of any contracts whatsoever. They argue that it is far more important to build a relationship with business partners in China by visiting them, and inviting them in the home country (Holland).

The effect of not using contracts on the transaction cost list presented, is that there is a shift from the contract-related transaction costs to costs related to relationship investments (such as a visit to China). This does not mean, however, that all of the transaction costs bundled under the contract categories should not be considered. Many of these aspects still form fundamental parts of the business agreement, but should merely be agreed upon in a different way.

When one still wishes to use a contract, which some western firms still attempt to do, it is important to know whether there is any way of enforcing the agreed upon clauses. A contract is only worth so much as it can be enforced, and especially with
the risk of stressed relationships (due to Chinese partners that do not want to use a contract), it should be clear what the potential benefits are.

- **Tradefairs**

  Visiting tradefairs was one of the transaction costs mentioned in the previous section. In practice organizations acknowledge that tradefairs can be a useful tool either to find vendors that can make a specific product, or to learn about the competences of different vendors. An interesting finding that may save significant transaction costs in the category China visit, is that where some organizations decide to organize a trip to one of the Chinese trade fairs, in practice many of the Chinese vendors that are present in China, are likely to come to Frankfurt as well. It is therefore useful to find out the usefulness of making the more expensive and time-intensive trip to China.

- **Relationships and Competitors**

  In the transaction cost list a transaction cost is mentioned 'check vendor’s services to competitors'. It is important to elaborate on this point because in practice we find that this potential problem can have an impact on the organization’s competitiveness.

  One of the interviewees recalled that one time a product had been produced which was to be outsourced to China. Having made the drawings of what the product should look like, the organization sent these to their Chinese counterpart. Not long thereafter it turned out that one of the local (Dutch) competitors of the organization sold a replica of the product in Holland too. It would seem that there is a clear victim and clear wrongdoer in this case, and therefore a clear-cut case for a lawsuit. But when the Chinese counterpart simply denies that he has done anything (possibly to not lose face), and most likely with no contract to fall back on, this is not as easy as it looks.

  For this reason, performing an adequate due diligence of all aspects of the vendor, including its services to competitors, may save money later, and hedge the risk of losing one’s competitiveness.
- **Sample Product**

The final discrepancy relates to sample products. Sample products provide an ideal way to test the quality of the products a vendor can produce, while at the same time testing the vendor’s timeliness of delivery and willingness to do business. In practice, sample products are a routine part of the initial stages of outsourcing.

An interesting finding related to sample product testing, however, is first that one should bear in mind that the sample product does not always indicate the quality of future batches. It is therefore by no means an alternative for quality control. Multiple organizations have encountered this problem, which can cause considerable transaction costs in categories related to logistics and quality control in case the quality of an actual product batch is not the same as the sample product.

Second, some of the interviewees could not make use of sample products, in the simple (small investment) way. The reason, which is likely to be encountered by more organizations, is that a sample product would require a significant asset specific investment. An example would be products made of steel. Most of these products require a mould, these moulds can cost as much as €20,000. One of the interviewees wanted, for instance, to identify whether Vietnam was a more favorable option than China. He bought a €20,000 mould and ordered a batch of products. Eventually, the products were insufficient of quality and his investment was lost. One can imagine that these types of transaction costs can form considerable sunk costs.

To conclude, making use of sample products may be a way of saving costs when one does not have to make a large asset specific investment. It will help the organization benchmark vendors in terms of quality in price. When a relatively large asset specific investment is needed, this benchmarking becomes harder. Switching vendors will also be more difficult, hence exit strategies should take into account this point.
5.2 Market Outlook for Outsourcing to China

China is the largest exporting country in the world, and only second to the European Union. China’s total amount of merchandise exports on a free on board (f.o.b.) basis in US dollar was estimated by the CIA to be $1,204 billion in 2009 (approximately €945 billion). This number was calculated on an exchange rate basis.

Despite the economic crisis that started mid-2007, Chinese GDP growth remained strong. While Chinese exports plummeted, heavy government policy stimuli, most notably in the form of infrastructure investments, boosted Chinese GDP. In the midst of a seemingly recovering world economy, World Bank data states that exports have grown again also. In terms of the kind of trade China is active in, more than half of the export includes processing trade, while conventional trade covers a considerable part of total exports as well. According to Starmass International, a consulting firm, a trend can be noted in which processing trade export has declined from 2001 to 2007, while conventional trade increased during that period.

In the coming years, considerable change can be expected in terms of transaction costs related to importing from China. In this outlook, we consider several topics that were discussed with interviewees. This list is therefore not considered to be encompassing. However, we believe the list comprises plausible scenarios that have an impact on transaction cost management.

- **Production Costs**

One of the competitive advantages of producing in China is labour cost. Though still about 30% to 50% cheaper than Western counter parts, Chinese producers face increasingly higher wage cost and turnover. The Chinese labour force in large manufacturing areas such as Shanghai and Guangzhou is nowadays primarily supplied by migrants from the peripheral provinces. According to the China Household Income Project (CHIP), migrant wages have increased significantly over the past years, with increases of approximately 20% in the first half of 2010 in some industries. Also, the Chinese government, on various levels, opts for (higher)
minimum wages to lower social tensions and provide a safety net for the poor. This development has already led to minimum wages rising 30% in some provinces. As for the turnover, data of the Institute of Contemporary Observation, a Shenzen-based labour research group, shows that low-tech industries face turnover rates of approximately 50%. This is partly stimulated by increasing migrant labour mobility and pushes up wages as Chinese businesses struggle to retain personnel.

As higher wages push up production costs, outsourcing to China becomes more expensive. In terms of transaction costs, the higher wages will not affect transaction costs per se. Hence, it can be concluded that the potential increase in production costs will have a negative impact on the attractiveness of China as an outsourcing location without significantly influencing transaction costs. However, according to consulting firm McKinsey & Company (2008), China’s relatively low-cost production (in some industries still 35% less than developed markets) will still be its primary competitive advantage.

- **Renminbi Appreciation**

It is often argued that China is similar to other Asian countries in terms of exchange-rate policy. Countries such as Japan, South Korea and Taiwan have all adopted managed floats that allow their local currencies to fluctuate within a limited range over time (linked to the US dollar). In doing so, these governments limit the appreciation of their currencies and sustain growth-oriented surpluses.

Over the course of time, the Chinese government has loosened its restrictions on the currency (range pegged to the US dollar) to allow for slight appreciations. The steady appreciation of the Chinese yuan would lead to the reduction of global imbalances and flexibility in monetary policy. In terms of international trade, and the effect of yuan appreciation on individual entrepreneurs, outsourcing to China will become more expensive. Due to the European sovereign debt turmoil, and the consequent climb of the US dollar in relation to the Euro, costs in yuan are likely to be even higher for European outsourcers as the yuan is still pegged to the US dollar. To give an indication of the exchange-rate swings, the US dollar rose approximately
15 per cent against the Euro between November 2009 and Mid July 2010. This has translated into a similar appreciation of the renminbi against the Euro.

With regard to the list of transaction costs, an appreciation of the yuan entails primarily higher production costs. However, costs that have to be paid in Chinese yuan, incurred by outsourcing organisations, also increase. Here, one should think of the payment of service providers in China and costs related to product adjustments. Overall, the appreciation of the yuan increases the cost of outsourcing to China, thereby reducing the attractiveness of China as an outsourcing location.

**Transport Costs**

According to CIBC World Markets Inc., a wholesale banking arm of an U.S.-based bank, transportation costs form a threat to globalisation and international trade. It is argued that, nowadays, higher energy prices are the largest barrier to global trade. In the last 15 years, fuel consumption has doubled per unit of freight. Oil prices thus form a significant and increasing cost in international transport. According to CIBC, a US dollar rise in world oil prices translated into a 1% rise in transport costs. The following figure shows this.

![Figure 5.1](image.png)

*Figure 5.1, Source: CIBC World Markets Inc. (2008)*
In figure 5.1, the West Texas Intermediate (WTI) price in different time periods are given, including a forecast. Here, one can see that there is an increase in significance of fuel cost in relation to other costs. Because of this significance of oil prices, the distance to be covered is also very relevant in considering total costs. Again, according to CIBC, every 10% increase in covered distance leads to a 4.5% increase in transport costs. In the case of China, CIBC comes up with the following example for the U.S.:

The time it takes for a shipment from China to North America is approximately four weeks. Taking inland transport into account, the cost of shipping a standard 40-foot container from Shanghai to the Eastern United States currently costs $8,000. To illustrate the significance of oil prices, in 2000 the oil prices were $20 per barrel and transport costs consequently were $3,000. In a scenario in which the oil price per barrel shoots up to $200, the transport price for the same container costs $15,000. This relationship can be seen in figure 5.2.

![Figure 5.2, Source: CIBC World Markets Inc. (2008)](image)

When one adds the fact that transportation costs, other than oil prices, are commonly set at the time of shipment by the third-party, and cargo shipment terms are often free on board (rather than an all-in cost to the foreign port), outsourcers face most of the transport costs.
- **Green lanes Development**

Green lanes are transport routes in which the previously discussed authorised economic operators (AEO) are active. The Green Lanes comprises of operators that satisfy certain standards, thereby reducing uncertainty with regard to operators’ operations and abilities.

At the moment, multiple Green Lanes exist in different parts of the world, with trials taking place already, for example between the port of Rotterdam and Shanghai. The World Customs Organisation (WCO) created a framework of standards (SAFE) that should lead toward the harmonisation of international customs, setting the tone for enhanced inter-custom cooperation.

SAFE puts emphasis on the international harmonisation of supply chain security standards, electronic cargo information, and risk management. Consequently, customs should have more trust in authorised economic operators, which leads to enhanced efficiency and lower transport costs.

Although the green lanes can have significant impact on transaction costs (reduced delay as a result of customs scans for instance), a problem that the Dutch customs face is that it requires a significant investment to ensure that the organization meets all SAFE criteria. Hence, for smaller organizations, the investment is too large to outweigh the benefits. Also, a potential problem would be that the Dutch customs are required to check a certain amount of containers per year for safety reasons. In case a majority of the importing organizations comply with SAFE criteria and are thus part of a green lane, the minority that is not part of a greenlane will face all (or almost all) cargo scans. This may be greatly reduce the incentive to import for smaller firms for which it is hard to meet the SAFE criteria or for entrepreneurial firms that wish to do business in less-established parts of the world (and thereby making the investment to be an AEO more significant).
Internal Competition
A current trend discussed during the interviews regards the increasing size of Chinese manufacturers, to the extent that some vendors are the primary supplier to most retailers in the Netherlands. The economies of scale that these suppliers can achieve make them significantly more attractive to retailers than small suppliers. However, this results in competing firms buying from the same supplier.

Here, one should take into account the legal enforcement in China, which is not yet as developed as is desired by most Western retailers. Orders for Chinese producers are relatively easily copied by other (and even the same producer) to also supply other outsourcing firms. The regulatory environment of China therefore has to improve – and is improving – so as to make investment decisions in China more attractive and reduce transaction costs that result from uncertainty and copyright infringement.

6. Limitations and Recommendations for Future Research
As a result of the well-defined scope of this project, it is clear that this report opens the door to numerous further research opportunities. In this section we attempt to uncover some of these future research prospects that can follow this study. We will do so under four different headings, each on a slightly different level. We recognize the fact that there are more possibilities for future research, some of which result from the choices discussed in the introduction of this report, but we believe the selected four options would have the most value.

1. Practice
When conducting this study, we gained insights from practice-oriented literature studies, and from interviews with experts and practitioners. It may be valuable, however, to actually perform part of the process. This would not only help verifying the list of transaction costs, but by thoroughly documenting the steps performed, it may also provide more insight into the possible ways to improve the process of outsourcing. Little elaborate documentation can be found about the specific steps of the outsourcing process. One can think about performing smaller or larger parts of
the process. Examples would be actually attending a trade fair, visiting suppliers, visiting the process performed by customs, and actually importing a product.

2. Case Study Competition
To inform more people of the importance of transaction costs in international business/trade, events such as case competitions can be organised. For example, a case study competition can involve (teams of) students who have to come up with a solution to a specific case study that involves transaction cost management. It might be a good idea to link such as competition to real-life transaction cost issues faced by organisations. These organisations can be governmental and non-governmental. Such an initiative would have the following benefits:

1. Increase awareness of transaction costs among the student population and all organisations involved.
2. The insights and ideas of the participating students can be used to tackle actual issues related to transaction costs.
3. The attention such an event draws gives contributing organisations (Stichting Handelsland) positive exposure and promotes its activities.

3. Qualitative Research
Where our research so far has been able to identify interesting transaction costs and divergences from the theoretical list of transaction costs, it can only be considered a small scale study. In order to enhance the list of transaction costs and to create an even better view of where practice often diverges from the more obvious path, more interviews with practitioners would be a valuable addition. The interviews should focus on the complete process of outsourcing. Only by focusing on the details of the steps in this process one can come to interesting findings. In our experience it is useful to build on the list provided in this report. By means of benchmarking outsourcing processes of other organisations with the list provided here, valuable insight could be gathered on possible divergences.
4. Quantitative Research

In order to shed light on the relative importance of the different transaction costs presented in this report, a similar approach as the qualitative research can be taken. However, now we present the transaction cost list to outsourcers and ask them to provide a score for various groups of transaction costs. This information can be gathered in a database and processed. To realise this initiative a number of steps should be taken:

When one has verified the transaction cost list presented in this report by means of the previously described qualitative research, the list can be translated into a set of measures. These measures will consist of bundled transaction costs (e.g. search costs).

Then, the measures can be put in a questionnaire that is subsequently filled out by practitioners of outsourcing. The respondents weigh the constructed transaction cost measures in terms of their relative importance (e.g. 5-point Likert scale). Possibly practitioners can allocate actual amounts (or percentages) to the different measures. The information gathered through these questionnaires can be collected in a database. This data can then be analysed for the statistical significance of each of the transaction cost measures. From this analysis, results might indicate opportunities for transaction cost reductions. This knowledge can translate into advisory services and awareness of the significance of transaction costs.
7. References