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When do formal control and trust matter? A context-based analysis of the effects on marketing channel relationships in China

Zhilin Yang [a], Chen Zhou [b], Ling Jiang [c,*]

[a] School of Management, China University of Mining and Technology, Jiangsu, China; Department of Marketing, City University of Hong Kong, Kowloon, Hong Kong
[b] Department of Marketing, Pennsylvania State University, University Park, PA 16802, USA
[c] Faculty of Management and Administration, Macau University of Science and Technology, Taipa, Macau

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ABSTRACT

Formal control and trust are two typical governance mechanisms employed to safeguard business transactions. Yet the effectiveness of each mechanism for firm relationship outcomes remains unclear. Some relevant literature suggests that formal control and trust simultaneously can help secure transactions, whereas other research argues the two control mechanisms can substitute for each other. This study applies social embeddedness theory and differentiates strong tie from weak tie relationships. In so doing, it reveals the role of strong versus weak social ties in leading to parallel conclusions about the relationship between formal control and trust and their effects on relationship outcomes. On the basis of empirical tests in a Chinese marketing channels context, this study finds that the joint effects of formal control and trust on governing transactions depends on the relational tie that the focal partners share. Specifically, formal control and trust complement each other only in weak tie relations. On the basis of this new perspective, the authors offer theoretical and managerial implications for managing interfirm governance mechanisms in transitional economies such as China.

1. Introduction

In the field of interfirm relationships in general, and marketing channel management in particular, formal control and trust rank as vital governance mechanisms that can safeguard transactions (e.g., Das & Teng, 1998; Poppo & Zenger, 2002). Yet the effectiveness of each mechanism for firm relationships remains almost mythological. Disputes regarding the contingency of formal control and trust continue to rage, as one literature stream (e.g., Dyer, 1997; Gulati, 2007; Lincoln & Gerlach, 2004; Nooteboom, Berger, & Noorderhaven, 1997; Poppo & Zenger, 2002) suggests formal control and trust reinforce each other and can apply simultaneously as means to safeguard transactions, even as another body of research argues that the two control mechanisms are actually substitutes for, or even exclude, each other, such that their simultaneous presence contributes nothing further of value to the transactions (e.g., Mayer & Argyres, 2004; Ryall & Sampson, 2009; Wuyts & Geyskens, 2005).

These two research streams actually explore the same problem, namely, how formal control and trust work contingently. The critical question that neither has answered remains: Why do these studies achieve such conflicting conclusions? This research gap is truly significant in its implications, for it prevents us from gaining a clear understanding of the functions of formal control and trust as transaction safeguards (Bijlsma & Koopman, 2003), which in turn can provide a foundation for further studies of channel governance problems.

We posit that a firm's governance strategies depend strongly on the relational ties embedded in its economic settings (Granovetter, 1985). Therefore, differentiating interfirm relationships according to their relational tie qualities may help reveal the appropriate control strategies. By examining both strong and weak relational ties, we propose a novel approach in which formal control and trust actually have context-based effects, such that the context of strong ties or weak ties determines whether they exclude or reinforce each other. Such differences also should prompt distinctions in their influence on other transactional factors.

The objective of this study therefore is to explore how context effects (i.e., social ties) exert distinct influences on the mechanisms associated with formal control and trust and thereby affect key relational outcomes (i.e., long-term orientation and opportunism in this study). This research not only contributes to filling the existing theoretical gap but also provides insights into the more effective management of interfirm relationships. We choose Chinese marketing channels as our research setting, because China is well known for its long-standing practice of guanxi in business contexts. Therefore, it provides an ideal setting in which to test the influences of social

* Corresponding author. Faculty of Management and Administration, Macau University of Science and Technology, Avenida Wai Long, Taipa, Macau. Tel.: +86 853 88972905; fax: +86 853 28880022.
E-mail addresses: mkzyang@cityu.edu.hk (Z. Yang), cxz159@psu.edu (C. Zhou), jianglingmail@126.com (L. Jiang).

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relationships on the choice of interfirm governance mechanisms. In turn, the findings gathered from this representative transitional economy can enrich and enhance our understanding of channel management overall.

2. Literature review

2.1. Formal control and trust

Formal control has its roots in transaction cost economics (TCE) theory, which advances two basic behavioral assumptions about people: bounded rationality and opportunism (Williamson, 1996b). According to TCE, it is impossible for firms to predict situations clearly ex ante (before the transaction) because of their bounded rationality, which makes opportunistic behaviors pervasive in the absence of effective governance. These two behavioral assumptions use, as their foundational logic, the concept of calculativeness (Williamson, 1993). In this context, bilaterally credible commitments play a vital role prior to the implementation of transactions, inasmuch as focal parties dare to continue risky transactions only in the presence of credible commitments (Williamson, 1996a). Formal control is one method to ensure credible commitments (Williamson, 1996a).

Formal control refers to “a regulatory process by which the elements of a system are made more predictable through the establishment of standards in the pursuit of some desired objective or state” (Leifer & Mills, 1996: 117). A representative approach in agency theory (Sundaramurthy & Lewis, 2003), formal control features impersonal, lawful, and institutionalized control mechanisms, such as detailed contract drafting (Wuyts & Geyskens, 2005) and monitoring (Anderson & Oliver, 1987). It can help guard against environmental uncertainty (Williamson, 1985), as well as alleviate information asymmetry by revealing the degree to which a party conforms to agreed-on terms (Balakrishnan & Fox, 1993). Similar to TCE, agency theory relies on the assumption that human beings are self-interested and opportunistic in their behavior (Sundaramurthy & Lewis, 2003), so formal control strategies achieve mutual control by specifying clear boundaries (Das & Teng, 1998) and revealing the degree to which the supplier complies with agreed-on terms (Houston & Johnson, 2000).

Trust offers an alternative governance structure that resides within the social relationship between and among individuals (Uzzi, 1997). Trust refers to the degree to which the trustor holds a positive belief about the trustee's goodwill and reliability in a risky exchange situation (Das & Teng, 1998; Gambetta, 1998; Nooteboom et al., 1997; Ring & Van De Ven, 1994). Although both sociologists and economists associate trust coincidentally with risk, they differ according to whether the “trust” behavior is driven by calculativeness. In sociological theories, trust aligns with cooperation driven by loyalty to a partner due to ethics or bonds of friendship or kinship, rather than coercion or material self-interest; therefore, the partner chooses not to defect despite both the motive and the opportunity to do so (Nooteboom, 1996). In other words, trust affects the partner's behaviors through intrinsic instead of extrinsic motivations (Nagin, Rebitzer, Sanders, & Taylor, 2002). Interorganizational trust also serves as a governance mechanism (Bradach & Eccles, 1989) that safeguards proper behaviors in exchange relationships characterized by uncertainty and dependence (Doney & Cannon, 1997; Pfeffer & Salancik, 1978). The benefits of interfirm trust in strategic alliances are wide-ranging in character, including lowering transaction costs (Das & Teng, 1998; Gulati, 1995), inducing desirable behavior (Madhok, 1995), reducing the extent of formal contracts (Larson, 1992), and facilitating dispute resolution (Ring & Van De Ven, 1994).

Scholars further categorize trust into two main types (e.g., Mayer, Davis, & Schoorman, 1995). Capability trust emphasizes “the expectation of technically competent role performance” (Barber, 1983; p.14), whereas goodwill trust refers to “the expectation that some others in our social relationships have moral obligations and responsibility to demonstrate a special concern for others' interests above their own” (Barber, 1983: p.14). We consider trust as a single concept with an emphasis on the “goodwill” dimension, so as to establish a contrast with formal control.

Although formal control and trust represent two governance structures derived from distinctive disciplines, much relevant literature considers them jointly and discusses their combined effects on interfirm relational outcomes. Regarding the joint effect of formal control and trust, existing literature achieves two main conclusions, namely, substitutes and complements.

2.2. Formal control and trust as substitutes

Formal control and trust may be substitutes in their function of safeguarding transactions; their independent impact against opportunism might be mitigated if they were employed together (Aiken & Hage, 1966; Barkema, 1995; Bernheim & Whinston, 1998; Das & Teng, 1998; Frey, 1993; Ghoshal & Moran, 1996; Gulati, 1995; Wuyts & Geyskens, 2005). First, applying formal control strategies and trust simultaneously may be redundant, because both strategies serve the congruent goal of suppressing opportunistic behavior (Dyer & Singh, 1998). Thus, the existence of goodwill trust makes it unnecessary to specify or monitor contractual clauses (Dyer & Singh, 1998). Because both applying formal control strategies and maintaining trust relationships involve considerable costs in terms of time and efforts, firms must concentrate on one or the other, not both (Wuyts & Geyskens, 2005). In their experiments, Ben-Ner and Putterman (2009) confirm that contracts are largely unnecessary to mandate trusting and trustworthy behaviors.

Second, the psychological reaction of a party may differ when the other party applies these strategies. With an assumption of egocentric human motivation, formal control strategies prevent one party from engaging in opportunistic behaviors by extrinsically coercing it with articulated terms, clauses, and sanctions (Williams, 1988). In contrast, trust relies more on intrinsic ethics, values, and norms that assume relatively nonegocentric human motivations to regulate proper conduct (Williams, 1988). Ghoshal and Moran (1996) argue that the use of formal control signals, to the extent that one party distrusts the other, lead to distrust that breeds distrust, enhancing the other party's psychological reaction and thereby promoting inappropriate actions, such as opportunistic behaviors (Nooteboom, 2004). Bernheim and Whinston (1998) further suggest that making contracts more explicit may encourage opportunistic behavior in the form of actions that cannot be specified within contracts, because such systems involve auditing, monitoring, and the adoption of administrative lines of authority and subordination. Increased opportunistic behaviors may have serious adverse effects on the work “atmosphere,” encouraging perfunctory instead of cooperative behavior. Moreover, the lack of trust and confidence associated with the expectation of opportunism probably encourages people to behave in a postulated opportunistic fashion (Moschandreas, 1997).

Whereas most studies in this research stream address the joint effects of formal control and trust conceptually, two studies delve more deeply into this problem by employing empirical tests. Das and Teng (1998) explore the joint effect of formal control and trust on confidence in partner cooperation. They define formal control as “a regulatory process by which the elements of a system are made more predictable through the establishment of standards in the pursuit of some desired objective or state” and trust as “the degree to which the trustor holds a positive attitude toward the trustee's goodwill and reliability in a risky exchange situation” (Das & Teng, 1998:p.494). They therefore conclude that formal control and trust achieve a substitutive joint effect instead of a complementary one, because formal control suggests a lack of belief in goodwill.