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# The moderating effect of interdependence on contracts in achieving equity versus efficiency in interfirm relationships

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## ABSTRACT

By associating the functions of contracts as safeguarding with equity or coordination with efficiency, this study explores the moderating effects of interdependence, operationalized as joint dependence and dependence asymmetry, on the relative salience and effectiveness of contracts in achieving equity versus efficiency in interfirm relationships. Analyzing the data from a sample of 355 retailers, the study finds that a higher contract complexity generates (1) steady gains in equity and increasing gains in efficiency as joint dependence strengthens and dependence asymmetry remains constant, suggesting a growing salience of the coordination function; and (2) increasing gains in equity and steady gains in efficiency as dependence asymmetry enlarges and joint dependence remains constant, reflecting a growing salience of the safeguarding function. By showing how interdependence moderates the relative effectiveness of contracts in achieving equity versus efficiency, the study enriches the literature on the complex and contingent roles of contracts in governing interfirm relationships.

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## 1. Introduction

Equity and efficiency are two major goals to interorganizational relationships (IORs) (Doz, 1996; Ring & Van de Ven, 1994). Equity implies that all parties receive benefits proportional to their investments and efforts (Ring & Van de Ven, 1994), with little opportunism directed towards their specialized assets or their shares of returns; efficiency implies that the relationship produces as large an output as possible from the given set of inputs (Farrell, 1957), with minimum waste of resource value caused by coordination lapses.

To ensure equitable and efficient relations, firms rely on various governance strategies, and formal contracts in particular, to curtail opportunism and smooth coordination. Over time, the literature views contracts more as safeguarding mechanisms against opportunism (Poppo & Zenger, 2002; Williamson, 1985). According to this prevailing logic, contracts may help to yield a higher level of equity by obliging firms to contribute resources and capture value as agreed, due to its legal-binding power to circumscribe legitimate behaviors and its signals of relationship recurrence (Gulati, Wohlgezogen, & Zhelyazkov, 2012; Poppo & Zhou, 2014). However, more recent work considers contracts as coordination mechanisms that help synchronize resource integration

and facilitate value creation efficiency (Gulati et al., 2012). Following this line of reasoning, contracts can diminish coordination lapses by specifying labor divisions, operating procedures, communication arrangements, and contingency planning (Malhotra & Lumineau, 2011; Mellewig, Madhok, & Weibel, 2007; Mesquita & Brush, 2008).

While the literature acknowledges the multifunction of contracts in facilitating equity and efficiency (Gulati et al., 2012), little work discerns when and which function of contracts is more salient in governing IORs. As a notable exception, Mesquita and Brush (2008) tested the contingent roles of contracts on asset specificity and production complexity. To extend the research, the present study explores the moderating effect of interdependence on the relative effectiveness of contracts in achieving equity versus efficiency in IORs.

Interdependence, operationalized as joint dependence (i.e., sum of each firm's dependence on its partner) and dependence asymmetry (i.e., difference between the firm's dependence on its partner and the partner's dependence on the firm), refers to the extent to which the two partners to an IOR mutually need important and irreplaceable resources from each other (Emerson, 1962; Geyskens, Steenkamp, Scheer, & Kumar, 1996; Kumar, Scheer, & Steenkamp, 1995). It is a crucial concept in the research on interfirm governance. The evidence shows that joint dependence and dependence asymmetry have diverse effects on partners' concerns and expectations towards the relationship, and thus their way to govern the relationship (Gulati & Sytch, 2007; Scheer, Miao, & Palmatier, 2015). It is found that, *ceteris paribus*, a

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high joint dependence makes for more cooperative atmosphere that inhibits coercive strategies (Gulati & Sytch, 2007; Gundlach & Cadotte, 1994; Kim, 2000). Although dependence asymmetry may have positive (Lusch & Brown, 1996), negative (Frazier & Summers, 1986), or no (Gundlach & Cadotte, 1994; Kim, 2000) effect on coercive power exercise, it creates the *potential* for opportunism—the less dependent firm faces temptation to exploit its power advantage while its partner endures the fear of being exploited (Casciaro & Piskorski, 2005; Geyskens et al., 1996; Kumar et al., 1995). It is thus plausible that the threats of opportunism may decline as joint dependence strengthens and elevate as dependence asymmetry enlarges. This may alter the relative focus of contracts in curtailing opportunism or smoothing coordination and thus their relative effectiveness in ensuring equity versus efficiency.

The paper builds upon and supplements three streams of research. First, by testing the moderating effect of interdependence on contracts as either safeguarding or coordination tools, it extends the understanding on the complex and contingent roles of contracts in governing IORs. In addition, it stimulates more attention to identifying other moderators, such as relationship phases and behavioral and environmental uncertainties, so as to enrich the literature on the contingent roles of contracts. Second, the paper adds to the literature on governance choice, in particular equity or efficiency-motivated contract designing (Doz, 1996; Ring & Van de Ven, 1994), by showing how interdependence moderates the relative focus of contracts in achieving equity versus efficiency in IORs. Specifically, it theorizes and empirically demonstrates that, from contractual governance, the chief gain would be efficiency in exchanges in which joint dependence is higher, while the chief gain would be equity in exchanges in which dependence asymmetry is higher. Third, it helps expand the debate on the interplay between contractual and relational governance. It implies that relational governance, and trust in particular, would substitute contracts in safeguarding and complement contracts in coordination (Lumineau & Henderson, 2012; Mellewigt et al., 2007). Meanwhile, it also implies a need to consider trust and distrust as two distinct constructs (Lumineau, 2014) when studying the interplay between contracts and relational governance, due to its mutual focus on joint dependence and dependence asymmetry—while joint dependence breeds trust, dependence asymmetry creates confrontations and distrust (Casciaro & Piskorski, 2005; Gulati & Sytch, 2007).

## 2. Research hypotheses

### 2.1. Contract complexity and equity

Equity is one major goal that a successful IOR must accomplish (Ring & Van de Ven, 1994). It does not require equality in rewards; rather, it entails all parties receiving benefits in proportion to their investments (Ring & Van de Ven, 1994). Therefore, equity requires firms to neither shirk – contribute less than agreed – nor claim more benefits than agreed via misappropriation of partners' resources or benefits or via hold up (Gulati et al., 2012). However, according to transaction cost economics, such deviations are likely to occur, so firms often use contracts as safeguards to protect their specialized investments and their shares of benefits (Williamson, 1985) and obtain a fair rate of exchange.

Complex contracts can curtail *ex post* opportunism and help firms get their due pay as agreed in two ways. First, complex contracts specifying inputs and outputs, task review processes, performance benchmarks, and penalties for violations provide clear and legal-binding frameworks for investment and payoff allocations, narrowing the openings for opportunism (Mesquita & Brush, 2008; Poppo & Zenger, 2002). Second, contracts can also discourage opportunism by signaling relationship continuity expectation and assure partners to be rewarded through the repeated business (Poppo & Zhou, 2014).

In addition, while the *ex ante* contractual terms might be in the powerful firm's favor in an unbalanced relationship, contracts can still make

the weak firm better off. Because contract laws forbid unconscionability, contracts must meet, at least, the minimum requirement of fairness, which is also mutually-agreeable, otherwise the IOR cannot be set up (Ariño & Ring, 2010). Absent detailed contracts, the weak firm is vulnerable to the whims of its partner, but as contract complexity increases, contracts can, at the minimum, circumscribe what its partner can do in a more specific way (Lusch & Brown, 1996). As such, contracts help firms avert major losses caused by opportunism and obtain their due pay as agreed, although the share may not be equal.

**H1.** Contract complexity is positively associated with equity.

### 2.2. Contract complexity and efficiency

Efficiency is another goal that IORs seek for (Ring & Van de Ven, 1994). This research focuses on production efficiency in particular, which refers to producing a maximum outcome from the given set of inputs (Farrell, 1957). Different from the focus of equity on resource contribution and *value capture*, production efficiency stresses on *value creation* and entails the complementary resources of partners being well enmeshed to yield their utmost value, with minimum process losses caused by coordination lapses (Gulati et al., 2012). Since contracts can work as blueprints to coordinate firm actions towards a joint goal, they may be beneficial for improving production efficiency (Mesquita & Brush, 2008).

The coordination role of contracts is mainly embedded in provisions regarding labor divisions, operation procedures, communication arrangements, and contingency planning (Gulati & Singh, 1998). Complex contracts with such provisions, first, delineate compatible timing and sequencing of actions and productive combination of resources and capabilities, informing firms when and how to draw on each other's resources and jointly leverage their capability sets (Gulati et al., 2012). Second, complex contracts enable partners to exchange information regularly and reflect quickly to avert losses when disruptions such as production line breakdowns occur (Mesquita & Brush, 2008). Third, complex contracts detailed procedures and contingencies to resolve the reallocation of resources and efforts, which help reduce delays or other forms of dysfunctions that may otherwise damage productivity (Poppo & Zhou, 2014). In sum, a high contract complexity may limit the possibility and severity of coordination lapses, enabling firm resources to be fully utilized to yield satisfying outcomes.

**H2.** Contract complexity is positively associated with efficiency.

### 2.3. Moderating effect of interdependence

#### 2.3.1. Joint dependence

The literature suggests that, all else being equal, a greater joint dependence between two firms results in smaller threats of opportunism for both partners. According to bilateral deterrence theory, a collaborator's desire to engage in opportunism can be deterred by its expectation and fear of retaliation (Kumar et al., 1995). When joint dependence increases and dependence asymmetry remains constant, both firms possess growing power to damage each other, so retaliation is more destructive and threatening (Gulati & Sytch, 2007; Gundlach & Cadotte, 1994). Should any opportunistic attacks occur, the aggressor would suffer severe losses in return. Thus, the firms' concerns about opportunism and equity decline (Kumar et al., 1995).

Embeddedness logic tells a similar story from a different perspective: All else being equal, a greater joint dependence increases the relational embeddedness between collaborators, which can foster cooperation and substitute contracts in terms of safeguarding (Gulati & Sytch, 2007). As joint dependence increases (holding asymmetry constant), both firms receive more of the valued and irreplaceable resources from each other, and find it harder to switch to alternative

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