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Contract ineffectiveness in emerging markets: An institutional theory perspective☆

Zhigang Shou [a, *, 1], Xu (Vivian) Zheng [b, 1], Wenting Zhu [c, 1]

[a] Department of Marketing, Economics and Management School, Wuhan University, Wuhan 430072, PR China
[b] Department of Marketing, College of Business, City University of Hong Kong, Tat Chee Avenue, Hong Kong
[c] Department of Marketing, School of Business Administration, Southwestern University of Finance and Economics, Chengdu, PR China

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ABSTRACT

The effectiveness of contracts is bounded by the institutional environment in which they are designed and enforced. When firms form supply chain partnerships in emerging markets, they may experience *contract ineffectiveness*, which is defined as a firm's perceived limits of contracts with respect to safeguarding interests and coordinating activities. Specifically, we identify two institutional factors that may give rise to contract ineffectiveness, information transparency and legal enforceability, as they determine how effectively a firm designs and enforces a contract. In addition, we reveal that contract ineffectiveness prompts a firm to seek social ties, including business ties and political ties, to overcome the institutionally induced limits of contracts. These efforts, however, are moderated by the type of predominant pressure a firm bears. While equity pressure strengthens the relationship between contract ineffectiveness and a firm's pursuit of social ties, efficiency pressure weakens this relationship, because seeking social ties imposes an extra burden of efficiency. Tested by data collected from 187 distributors in China, our study reveals the institutional causes and the consequences of contract ineffectiveness, which is a common problem encountered by firms when forming supply chain partnerships in emerging markets.

1. Introduction

The role of contracts in governing business transactions has been well documented in the transaction cost theory (TCT) framework (Williamson, 1996). By specifying the roles, rights, and responsibilities of each party, the rules and procedures of transactions, and the remedies for contingencies, contracts enable firms to coordinate activities (Argyres et al., 2007; Lumineau and Malhotra, 2011; Salbu, 1997) and safeguard against opportunism (Poppo and Zenger, 2002; Zhou and Xu, 2012; Zhou et al., 2014). This in turn helps firms achieve efficient and equitable transaction outcomes (Poppo and Zhou, 2014; Ring and Van de Ven, 1994). This formal governance mechanism, however, has its limits (Cannon et al., 2000; Cao and Lumineau, 2015). For example, contracts are inherently limited in adapting to environmental uncertainties, thus allowing exchange partners to behave opportunistically in domains unspecified by contractual agreements (Cannon et al., 2000; Poppo and Zenger, 2002; Schepker et al., 2014). To overcome such adaptability-related limits of contracts, firms may turn to remedial governance mechanisms (Poppo and Zenger, 2002) such as dyadic relational governance, which involves developing relational norms and trust in governing transactions to enhance the capability of joint problem solving and safeguard against opportunism upon contingencies (e.g., Cannon et al., 2000; Poppo and Zenger, 2002). Supply chain management research has paid considerable attention to how contracts and relational governance substitute for or complement each other (Cao and Lumineau, 2015), with empirical evidence suggesting the possibility for both under different conditions (e.g., Cannon et al., 2000; Huber et al., 2013; Zhou and Poppo, 2010).

Yet the limits of contracts may also arise from the institutional environment in which contracts are designed and enforced, which

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* Corresponding author.
E-mail addresses: mkshou@whu.edu.cn (Z. Shou), xuzheng@cityu.edu.hk (X. Zheng), zwt0322@gmail.com (W. Zhu).
[1] The three authors contributed equally.

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has received scant attention in previous research. According to institutional theory (Grewal and Dharwadkar, 2002; Scott, 2001, 2014), the institutional environment in which a firm operates has a profound impact on the organizational structure and the functionality of contracts. In emerging markets where the legal and cultural commitment to the use of contracts has yet to be established, the effectiveness of contracts may be discounted (Peng, 2003; Zhou and Poppo, 2010; Zhou and Xu, 2012). For example, the *Business Confidence Survey* (European Chamber in China and Roland Berger, 2013) indicates that 76% of European companies lack confidence in the effectiveness of contracts in China, and they all regard the improvement of institutional environment as a key driver of the Chinese economy. In our study, we define *contract ineffectiveness* as a firm's perceived limits of contracts with respect to safeguarding interests and coordinating activities. When forming supply chain management partnership with different entities, firms may experience varied levels of contract ineffectiveness, which renders contract ineffectiveness a relationship-level construct. However, factors at other levels may also affect contract ineffectiveness. In our study, we take an institutional theory perspective and aim to examine the impact of institutional factors on contract ineffectiveness, which in turn prompts firms to seek remedial governance mechanisms (i.e., social ties). To do so, we need to overcome the following three limitations of extant research.

First, it is not clear what institutional factors may give rise to contract ineffectiveness. Specifically, because a contract is most effective when carefully designed and legally enforced (Argyres and Mayer, 2007; Zhou and Poppo, 2010), the institutional factors that may affect contract design, enforcement, and thus ineffectiveness are worth examining. Although a few studies have paid attention to the role of the institutional environment (e.g., legal environment hostility) (Cavusgil et al., 2004) in determining the effectiveness of governance mechanisms in general, they do not explain the rise of contract ineffectiveness directly. In addition, most have focused on factors that influence contract enforcement, and thus far, few studies have identified the institutional factors that may give rise to contract ineffectiveness by affecting a firm's ability to properly design a contract.

Second, few studies have investigated how firms respond to institutionally induced contract ineffectiveness by selecting different governance mechanisms. If, because of institutional voids, contracts cannot perform their intended functions of safeguarding interests and coordinating activities, what do firms do? Top managers' social networking with the business community and government officials is a widely spotted phenomenon in emerging markets. By providing additional market- and supplier-specific information and helping enforce contracts, social ties (including business and political ties) help firms overcome the limits of information factor markets and legal systems, protecting them against unlawful and opportunistic behaviors (Sheng et al., 2011; Xin and Pearce, 1996). To date, surprisingly few studies have disentangled the relationship between contract ineffectiveness and firms' efforts to seek social ties.

Third, as identified by prior research, achieving efficient and equitable transaction outcomes are two predominant goals firms pursue when selecting different governance mechanisms (Ariño and Ring, 2010; Ring and Van de Ven, 1994). Yet again, few studies have investigated how, in emerging markets where the effectiveness of contracts is discounted due to institutional deficiencies, efficiency and equity pressure may affect firms' efforts to seek alternative governance mechanisms. Under considerable efficiency pressure, for example, firms may be reluctant to continuously invest resources in establishing and maintaining ties with other business partners and government officials, because doing so may incur an extra burden of efficiency. Because prior literature on governance mechanisms has mainly taken an efficiency-based approach, as reflected in the TCT framework, empirical studies that consider how equity pressure, in particular, affects a firm's choice of governance mechanisms are lacking.

Our study attempts to address the aforementioned research gaps by answering the following two questions: (a) What notable institutional factors in emerging markets give rise to contract ineffectiveness? (b) How does the level of contract ineffectiveness, by itself and in combination with efficiency and equity pressure, affect firms' efforts to seek business ties and political ties? Integrating TCT and institutional theory, we build a conceptual framework that examines the impact of institutional factors of information transparency and legal enforceability on contract ineffectiveness, which in turn affects their efforts to seek social ties, with and without efficiency and equity pressure, in emerging markets (see Fig. 1 for the conceptual model). We test our hypotheses using primary data from 187 distributors in China, and the results provide strong support for our hypotheses.

Our study aims to offer the following contributions to supply chain management research. First, our study reveals a common concern of firms entering into a contractual relationship in emerging markets (i.e., contract ineffectiveness) and empirically tests its impact on firms' efforts to seek social ties. Based on prior research on the functionality of contracts, we formalize the conceptualization of contract ineffectiveness and provide the measurement for it. Second, we have identified two specific institutional factors that may give rise to contract ineffectiveness, information transparency and legal enforceability, which are defining characteristics of emerging markets and display significant variance across a country's regions and industries (Hoskisson et al., 2000; Luo, 2007; Meyer et al., 2009; Park and Luo, 2001). Third, our study delineates the boundary condition of developing social ties by showing how firms' efficiency and equity pressures, in joint consideration with contract ineffectiveness, affect firms' efforts to seek social ties. To our best knowledge, the current study represents one of the first efforts to empirically investigate the different roles of these two types of pressure in affecting firms' efforts to pursue social ties.

2. Theoretical underpinnings

2.1. Contract ineffectiveness and institutional causes

Signing a contract constitutes making a promise regarding the delineated obligations, duties, and responsibilities to the other party. By making such legally accountable promises, contracts enable firms to protect individual rights (Bolton and Dewatripont, 2005; Smith, 2004), safeguard against opportunism (Lumineau and Henderson, 2012; Zhou and Xu, 2012), and coordinate firms' activities to achieve desired goals of both parties (Lumineau, 2015; Reuer and Ariño, 2007). This viewpoint is echoed by transactional cost theory, which argues that contracts can minimize transaction costs through enabling greater administrative efficiency and deterring opportunism (Williamson, 1996).

Despite the importance of contracts, they are inherently limited. For example, incomplete contracts may fail to adapt to contingencies (Poppo and Zenger, 2002) and thus become "inefficient mechanisms of governance in the face of uncertainty" (Cannon et al., 2000, pp. 182–183). Moreover, in an institutional environment in which the legal and cultural commitment to the use of contracts has yet to be established, the intended functions of contracts may not be fully realized. For example, Zhou and Poppo (2010) found that the lower the perceived legal enforceability, the lower the credibility of contracts in safeguarding one's interest. Consequently, firms may encounter *contract ineffectiveness*, the