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Governing local supplier opportunism in China: Moderating role of institutional forces

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A B S T R A C T

China provides a vast and prominent manufacturing base, so curtailing its local supplier opportunism represents a primary concern for local and foreign buyers. Drawing on institutional theory, this study examines how regulatory uncertainty and relationship structure moderate the role of contracts and trust in restricting local supplier opportunism in China. An analysis of 293 buyer–supplier dyads in China reveals that contracts are more effective in deterring supplier opportunism when regulatory uncertainty is high. In addition, contracts help curtail opportunism more in domestic, compared with international, buyer–supplier relationships, whereas trust is more effective in restricting supplier opportunism in international relationships than in domestic ones.

1. Introduction

In the past two decades, China has become the most important manufacturing base for global purchasers, generating more than 20% of manufacturing activities in the world (National Accounts Statistics, 2013). Despite its strategic importance, the environmental uncertainties and operational complexities in China challenge local and foreign investors (Zhou et al., 2014). China's institutional environments are fast changing, and the factor markets underpinning its business operations are underdeveloped, elevating the difficulty of predicting and managing supply chain activities (Peng, 2003; Yang et al., 2012). For example, opportunistic exploitation of supply chain participants by other members of the supply chain impairs efficiency, hinders task accomplishment, jeopardizes cooperation, and even can disrupt partnerships or supply chains overall (Liu et al., 2009). Mitigating local supplier opportunism and improving operational performance thus are central challenges for both local and foreign buyers in China (Zhou and Xu, 2012).

Previous supply chain governance literature highlights two mechanisms to mitigate opportunism: formal governance, such as contracts, and informal governance, such as trust (Liu et al., 2009; Lumineau and Quélin, 2012). Contracts provide a formalized framework that specifies the details of the transaction, exerts punishments for contract violations through legal enforcement, and reduces incentives for opportunistic behaviors (Joskow, 1987; Williamson, 1996). For example, Lenovo, a top computer manufacturer in China, adopts detailed formal agreements with its suppliers so as to take full control of the operational procedures (Feng, 2011). In contrast, trust reduces transactional risks by promoting an implicit understanding of mutual goals, facilitating information sharing among supply chain participants, and encouraging a shared identity to ensure ongoing transactions (Cai et al., 2010; Heide and John, 1992; Wathne and Heide, 2000). For example, by offering more autonomy to local partners, Panasonic emphasizes the role of trust in China and obtains great flexibility from its collaborative relationship with local partners (Wakayama et al., 2012). Both contracts and trust are prominent governance mechanisms; prior supply chain literature emphasizes that their efficacy is contingent on the context, including macro-level institutional environments (Cao and Lumineau, 2015; Zhou et al., 2014).

In emerging markets, regulatory agents (mainly central and local governments) have a strong influence in regulating economic exchanges (Sheth, 2011). In China's “pragmatic” approach to market reform (Child and Tse, 2001), the development of its formal institutions has been characterized by intensive governmental

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intervention. The lack of a well-established, transparent legal system also has prompted both central and local governments to launch and change regulatory policies often in guiding business operations (Cai et al., 2010; Luo, 2007; Peng and Luo, 2000). Supply chain participants thus may choose the governance mechanism that is optimal for them and circumvent uncertainty in the regulatory environment (Williamson, 1985). Although governance literature highlights the uncertainty that arises from task environments (e.g., technology or market uncertainty; Carson et al., 2006; Germain et al., 2008; Krishnan et al., 2006; Wang et al., 2011), we know little about how regulatory uncertainty moderates the success with which governance mechanism can constrain supplier opportunism (Cao and Lumineau, 2015).

The efficacy of these governance mechanisms also is a function of cooperation between and involvement by both parties to the transaction, because contract governance relies on communal understanding and an interpretation of each party's roles and obligations, whereas relational governance hinges on mutual consent from each party (Williamson, 1996). The institutional distance associated with local and international partners may subject foreign partners to great cognitive constraints though. Weber and Mayer (2014) state that cognitive limits would give rise to interpretive uncertainty. As China's institutions are transforming and inconsistent, foreign buyers with distant institutional backgrounds may find it difficult to well perceive and interpret the external rules (Cai et al., 2010; Yang et al., 2012; Zhou and Xu, 2012), resulting in a differential behavioral pattern and altering the value of various governance mechanisms in constraining supplier opportunism (Li et al., 2010a; Luo, 2005; North, 1990). Therefore, we argue that it is necessary to account for the impact of institutional distance on contracts and trust as tools to deter opportunism in supply chains in China.

Drawing on institutional theory (North, 1990; Scott, 1995), this study investigates the interplay of governance mechanisms and institutional contingencies in suppressing supplier opportunism in China. First, we examine the contingent effect of regulatory uncertainty within China on the role of contracts and trust in suppressing supplier opportunism. Second, we distinguish between local buyer–local supplier relationships (hereafter, *domestic relationships*) and foreign buyer–local supplier relationships (hereafter, *international relationships*), and use the *relationship structure* as a proxy for the institutional distance between two supply chain partners to examine the contingent value of contracts and trust in suppressing opportunism.

Our study thus makes several contributions to operations management literature. First, we extend the transaction cost economics and relational exchange perspectives of supply chain governance to an institutional view, which provides a more comprehensive understanding of the value of contracts and trust in constraining supplier opportunism. Second, we remind foreign entrants of potential interpretive uncertainty and information asymmetry due to institutional distance and provide specific governance guidelines for multinational enterprises to safeguard their interactions with local suppliers in China. Our study in turn sheds new light on the differential roles of contracts and trust in constraining supplier opportunism under various institutional conditions.

2. Theory and hypotheses

2.1. Opportunism and supply chain governance

Opportunism, defined as "self-interest seeking with guile," is a deceit-oriented violation of transactional promises (Williamson, 1985, p. 6), which can manifest itself in various forms, such as deliberately withholding information during the relationship initiation stage and providing false information over the course of transactions (Cavusgil et al., 2004; John, 1984; Wathne and Heide, 2000). Such shirking and cheating behaviors incur substantial transaction costs and undermine transaction efficiency in economic exchanges (McCarter and Northcraft, 2007; Morgan et al., 2007; Tangpong et al., 2010). Because supply chain participants often possess different and even incompatible goals, opportunism may be unavoidable, which makes safeguarding devices indispensable and critical in supply chain management (Liu et al., 2009).

The transaction costs perspective recognizes the role of contracts in preventing interorganizational opportunism (Williamson, 1985). *Contracts* refer to the extent to which transaction parties' roles and obligations are explicitly codified in a written format (Lusch and Brown, 1996). Serving as a formal governance mechanism, contracts offer a clarified framework for supply chain members to safeguard their exchange against opportunism in several ways. First, by fleshing out implicit assumptions, contracts mitigate operational misunderstanding and obviate excuses for seeking passive opportunism, in terms of the avoidance of action (Seggie et al., 2013). Second, contracts improve operational transparency, in that codified provisions serve as the benchmark against which exchange parties can effectively monitor ongoing operations and identify potential deviations quickly (Cavusgil et al., 2004; Lumineau and Henderson, 2012). Third, contracts deter opportunism by imposing legislative and economic sanctions on unethical or unlawful conducts. With effective legal systems underpinning contract enforcement, exchange participants can appeal to the legal system to protect themselves against opportunism (Joskow, 1987; Zhou and Poppo, 2010).

In contrast, relational exchange theory advocates the role of informal governance mechanisms, such as trust, in constraining opportunism (Heide and John, 1992; Macneil, 1980). *Trust* refers to the belief or expectation that exchange partners are benevolent and capable (Kumar et al., 1995; Zaheer et al., 1998). Trust between buyers and suppliers curbs opportunism in several ways. First, it breeds an implicit understanding of exchange expectations and joint goals, which in turn motivate exchange partners to pursue collective interests rather than self-interest (Morgan and Hunt, 1994). Second, trust motivates bilateral knowledge flows and reduces information asymmetry, enabling exchange participants to identify unethical or unlawful behaviors (Ring and Van de Ven, 1992; Verbeke and Greidanus, 2009). Third, trust serves as a self-enforcing device, because a shared sense of identity drives transaction partners to adhere to trust norms and act in the best interests of the exchange and their partners (Anderson, 1988; Brown et al., 2000). A breach of predetermined promises would lead to social sanctions, including a loss of future business or network exclusion (Zhou and Xu, 2012), which can effectively deter opportunism.

The opportunism-deterring role of explicit contracts and trust has been well documented in previous studies (Cavusgil et al., 2004; Deeds and Hill, 1999; Liu et al., 2009; Nooteboom et al., 1997). For example, Liu et al. (2009) find that formal contracts significantly restrain opportunistic behaviors in buyer–supplier relationships, and Cavusgil et al. (2004) reveal that detailed contracts mitigate the opportunistic behaviors of local distributors. Nooteboom et al. (1997) find that trust constrains opportunism through shared norms and values, escalated empathy, and frequent communication. Deeds and Hill (1999) indicate that close partner relationships facilitate trust development, which helps safeguard against opportunism. We therefore treat the negative impact of contracts and trust on supplier opportunism as baseline propositions and focus more on the contingent effects of institutional factors.

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