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# Repeated moral hazard in international joint ventures: Inter-temporal culturally sensitive incentive schemes for hidden action

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### ABSTRACT

This paper studies a repeated game of contracting in International joint ventures (IJVs) on the basis of information asymmetries due to different cultural backgrounds. Reputational effects, renegotiation and cooperation between the players are analyzed by using formal models. The organization, success and failure of an IJV are determined by the effort levels induced in each stage of the life-cycle. Besides managerial efforts, the cultural distance and convergence influence the design of long-term contracts in form of incentives for efforts of cultural cooperation. This leads to a dynamic contracting over the life-cycle of an IJV, in order to avoid cheating and to enhance co-operation on a cultural and managerial level. The outcome is the design of inter-temporal, culturally sensitive incentive schemes as a new approach to contracting in IJVs.

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## 1. Introduction

An essential element of organizations is the willingness of persons to contribute their individual efforts to the cooperative system. Inadequate incentives mean dissolution, or changes of organization purpose, or failure to cooperate. Hence, in all sorts of organizations the affording

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of adequate incentives becomes the most definitely emphasized task in their existence. It is probably in this aspect of executive work that failure is most pronounced.

Barnard (1938, p. 139)

The management of an organization is a dynamic process of interactions between different stakeholders and agents. It is often seen as a life-line of growth and decline. In International Business, Serapio and Cascio (1996) show examples of 'divorces' and with this the complexities of longevity, duration and termination of cross-border business relationships. Concerning the long-term relationship between players of international joint venture (IJV), structural changes and reconfigurations have to be considered over time (Yan and Gray, 1994). The likelihood that the perspective of contracting will change during the life-cycle is very high. Some authors (Yan and Zeng, 1999; Reuer, 2000; Luo, 2002; Ott, 2006) stress the importance of the re-negotiation of contracts and considered multiple contracts over an IJV life-cycle. Contracts can be seen as legal, economic and institutional forms of interactions between the parents and the management of an IJV. This raises the issue of the development of a long-term business relationship and the importance of reputation and renegotiation in a repeated game.

The termination of an IJV might be planned or unplanned, and thus the players may have a different time horizon in choosing their actions. Likewise, the liquidation of a joint venture can be on the one hand intended or on the other hand arise through the incompatibility of the partners occurring over the duration of the IJV. The knowledge of the end of the game has different strategies between the players as a consequence compared to the uncertainties of unplanned termination. These uncertainties in IJVs can be captured and designed in the contracting stage. Since the duration of the IJV-contract (short-term and long-term) has an impact on the behavior of the players to co-operate and/or to cheat, the reputation of the players and their ability to learn has to be taken into consideration.

This paper deals, therefore, with the possibility of incorporating different contracts depending on informational asymmetry arising during the management period and as a novel approach to model cultural distance and convergence by developing incentive schemes based on cultural sensitivity.

The paper's contribution lies in the consideration of the strategic and culturally sensitive behavior of the players and its influence on the incentive component of dynamic contracting. Repeated moral hazard games are applied to the cultural co-operation in an IJV. This has contractual and managerial implications and should facilitate the design of contracts over several stages. Specific contributions are the design of contracts based on the past records of performance and cultural cooperation as a guideline for improving repeated relationships and renegotiation.

## 2. Theoretical underpinning

There is a small but growing literature focusing on the life-cycle of IJVs such as Arino and De la Torre (1998), Brouthers et al. (1997), Brouthers and Bamossy (2006), Reuer et al. (2002), Ring and Van de Ven (1994), Shenkar and Yan (2002). These are based mainly on case studies. Jap and Anderson (2007) examine the evolution of cooperative inter-organizational relationships and provided an empirical test of propositions regarding a life-cycle theory of co-operative relationships. Furthermore, Luo (2002) not only shows the integration of transaction cost economics and sociological perspectives, but also the strengths and limitations of an empirical investigation into IJVs in China with cultural and contractual implications. Ott (2006) develops a body of research which spans from the set-up (adverse selection, signaling) through the managerial phase (moral hazard) to the termination (repeated moral hazard) of IJVs. Based on the game theoretical perspectives of multi-partner strategic interaction in IJVs, incentive schemes were developed which were adjusted to the various stages in an IJV life cycle and the order of the play showed the strategic interactions of the players and a means to avoid failure by offering paths of cooperation and conflict.

### 2.1. *International joint ventures and longevity*

Zhang and Rajagopalan (2002) find examples of cheating and credible threats in the repeated games of Sino-Japanese IJVs. Most local partners in developing countries contribute to the formation via

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