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ThinkBox

Informal contracting between and within firms☆

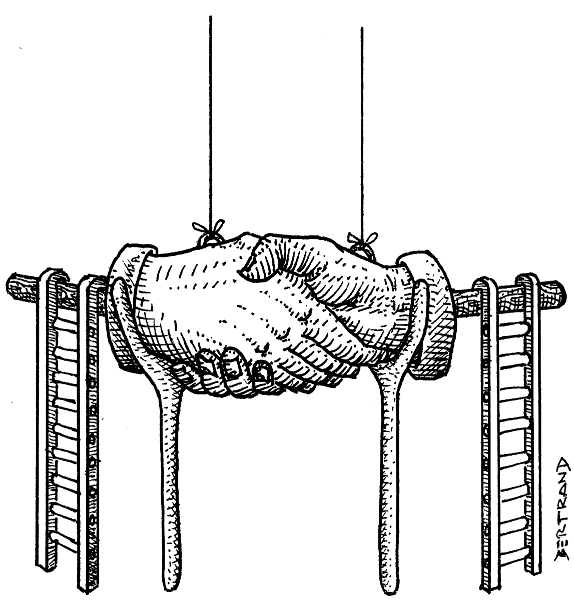
Ricard Gil[a,*], Giorgio Zanarone[b]

[a] *Johns Hopkins Carey Business School, Baltimore, USA*
[b] *Colegio Universitario Estudios Financieros (CUNEF), Madrid, Spain*

Abstract

While informal contracts are widely used in modern economies, limited systematic empirical evidence is available to researchers and policy makers. This paper aims to fill the gap by discussing a selected sample of empirical works through the lens of a theoretical framework that clarifies the role of informal contracts. We also highlight unexplored research opportunities offered by more recent theoretical models that investigate how informal contracts are built over time, how they are subject to path dependency, and how relational rents are created, and are awaiting empirical analysis.

Keywords: Informal contracts; Enforcement; Empirical evidence; Testability



Introduction

The existence and pervasiveness of *informal contracts*—that is, contracts that are enforced by parties rather than courts—has been extensively documented in social science. For instance, managers often rely on "hand-shake" agreements to support their deals (Macaulay, 1963); large corporations such as General Motors rely on informal, internally enforced routines to manage their workers and suppliers (Helper & Henderson, 2014); and long-distance traders enter commercial contracts even in the absence of reliable courts because they are afraid of being ostracized from the market, as under the medieval Law Merchant (Milgrom et al., 1990).

Inspired by these and other works, a rich theoretical literature has emerged in economics, investigating the conditions that make informal contracts feasible, their dynamic patterns, and the way formal contracts help sustain and enforce informal ones by reducing the parties' temptation to renege on their promises. This literature is summarized by MacLeod (2007), and Malcomson (2013). However, there is scarce systematic evidence on whether existing economic theories correctly predict the determinants and consequences of informal contracting. In this paper, we build on our recent work (Gil & Zanarone, 2015, 2016, 2017) to illustrate both the accomplishments and the research opportunities for empirical researchers in this field.

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* Corresponding author.
E-mail: ricard.gil@jhu.edu (R. Gil).

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Following Gil and Zanarone (2015, 2017), we begin by summarizing the key predictions received from economic models of stationary informal contracts—that is, contracts that do not change over time—and discussing recent empirical works that provide evidence on these predictions. In the second part of the paper, we suggest directions for future empirical research. On one hand, there are important untested predictions of stationary informal contracting model, particularly those on the coexistence and interaction between formal and informal contract. On the other hand, there are new theoretical predictions that await careful empirical analysis. In particular, the more recent economic models relax conventional simplifying assumptions—namely, symmetric information and the absence of liquidity constraints—and predict that far from being stationary, optimal informal contracts may gradually evolve over time, and may be subject to cycles of cooperation and path dependency. Following Gil and Zanarone (2016), we conclude the paper by discussing some strategies for testing the predictions generated by this new theoretical frontier.

Testing for informal contracting in stationary environments

The choice of enforcement regime

A first set of testable implications from the literature regard the choice of enforcement regime—that is, the extent to which contracting parties use formal or informal contracts to govern their transactions. In particular, because informal contracts are enforced by the parties' threat of terminating a long-term collaborative relationship, their use is predicted to increase when the parties have a long horizon and/or value future payoffs highly, when their outside options following breakdown of the relationship are not too attractive, and when their opportunity cost of honoring informal obligations, and hence their short-run temptation to breach, is not too large.

Ideally, to test these hypotheses we would need measures for the following variables. First, we would need a dependent variable indicating whether a formal contract exists. Second, we would need exogenous measures for the parties' intertemporal discount rate and their payoffs outside the relationship. Finally, we would need variation in the agent's opportunity cost of honoring an informal agreement. We discuss below two examples of empirical works testing this set of predictions. More examples, and a more technical discussion of the underlying econometric challenges, can be found in Gil and Zanarone (2015).

First, Gillan, Hartzell, and Parrino (2009) study the choice between explicit and implicit employment agreements (EAs) for CEOs in S&P 500 firms. They find that the use of explicit EAs (measured by an indicator for whether the firm's SEC filings report an explicit agreement) increases in the CEO's perceived uncertainty about the firm's future prospects (measured by sales volatility, the rate at which firms in the industry change ownership and control, and an indicator for whether the CEO is new to the firm). This result is consistent with the prediction because when the firm's prospects are uncertain (the intertemporal discount rate is high), promising a purely discretionary compensation to the CEO is not credible, because there's a high chance that the CEO-firm relationship will soon end, and hence the compensation promise will not be honored.

Second, Gil (2013) exploits a data set of movie exhibition contracts where 22 distributors place their movies on the screens of one Spanish exhibitor. The author had access to internal company records detailing whether distributors and the exhibitor used formal revenue-sharing terms or not. The paper shows that movies that did well during their US release (which occurs a few months earlier than the Spanish release) are more likely to use a formal contract than movies that were not released in the US, or were released but did not perform well. This result is consistent with the prediction because when the agreement is completely informal, the exhibitor, who collects revenues upfront, is tempted to renege, the more so the larger the movie's revenues. To mitigate the exhibitor's reneging hazard, movies with high expected revenues are governed by formal contracts, preventing the exhibitor from retaining the movie revenues.

Contracts and outcomes under a given enforcement regime

A second set of predictions in the existing literature regards the optimal actions and contract terms within a given enforcement regime (purely formal, informal, or a mixture of formal and informal). When the predictions differ depending on whether informal contracts are used or not, they allow us to indirectly test for the presence of informal contracts and their interaction with formal ones.

Corts and Singh (2004) study the choice between turnkey contracts (akin to fixed-price) and day-rate contracts (akin to cost-plus) in offshore oil drilling. Turnkey contracts provide drillers with stronger incentives to cut costs than day-rate contracts, but are also more rigid, and hence costlier to renegotiate when project specifications need to be changed. Using a sample of 1476 drilling projects, and an instrumental variable approach to control for the endogenous choice of drillers, Corts and Singh (2004) find that, all else equal, projects are less likely to be governed by a turnkey contract when the oil company and the driller have worked together in the past.[1] They interpret this result as evidence that informal self-enforcing agreements and formal incentive contracts (i.e., turnkey contracts) are substitutes, rather than complements.

Zanarone (2009) studies how vertical restraints in Italian car dealership contracts changed after a 2002 EU regulation prohibited manufacturers to assign dealers to exclusive territories. Among other results, he finds that, while contracts before the legal change mostly relied on quantity floors to contain dealers' double marginalization, contracts after the legal change contained a mix of both quantity floors and price ceilings. Zanarone (2009) shows that this result is inconsistent with purely formal dealership contracts, but consistent with the interaction of formal and informal provisions. If dealership contracts were purely formal, retail prices should decrease once

[1] Similar results are obtained by Kalnins and Mayer (2004) in a study of IT services procurement contracts.