How do Multinational Enterprises Mitigate Supplier Opportunism in Emerging Markets? Economic versus Social Exchange Perspective

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Abstract

In the globalization era, multinational enterprises (MNEs) have actively sought business opportunities by collaborating with local partners in emerging markets. Because of weak legal institutions in these markets, MNEs often face a challenge associated with local supplier opportunism. Built on economic and social exchange as well as institutional perspective, to mitigate supplier opportunism in emerging markets, MNEs should employ both explicit contracts and social relations in a complementary manner. Alternatively, MNEs should use unilateral centralized control to supplement contracts when they have superior negotiation power. However, the use of social relations and unilateral centralized control should be mutually exclusive because personal relationships may inhibit the effective use of hierarchical control. As legal enforceability in emerging markets improves, MNEs should consider employing more explicit contracts. Nevertheless, a hybrid mode of governance between contracts and social relations is usually required for doing business in these markets because moving from personal social exchange to impersonal economic exchange requires a fundamental change of traditional prevalent culture.

Keywords: buyer-supplier relationship; supplier opportunism; economic exchange; social exchange; institutional theory; multinational enterprise; emerging market

Introduction

In the globalization era, multinational enterprises (MNEs) have actively sought business opportunities by collaborating with local partners in emerging markets. MNEs which are mostly from more institutionally developed countries tend to employ formal contracts in dealing with local suppliers in unfamiliar emerging markets. Without being aware of the weak legal institutions in these markets, MNEs often encounter a challenge in how to mitigate the local supplier's opportunistic behavior in this cross-national interfirm relationship. The literature has explained partner opportunism in interfirm relationships from transaction cost economics (Williamson, 1985) and relational exchange perspective (Dyer & Singh, 1998). Economic development theory has suggested that formal institutions, such as courts and contracts, are able to govern complex market transactions more efficiently than informal institutions, such as social norms and personal relationships (North, 2005).

However, in emerging markets, legal systems that enforce contract law are not well developed (North, 2005). The lack of such formal institutions may undermine the use of contracts. MNEs in these markets may therefore need to rely on informal institutions such as personal relationships to govern their exchanges with local suppliers (Peng, 2003; Xin & Pearce, 1996). Although many emerging markets have increasingly transitioned toward a market economy, their traditions and customs may impede MNEs from embracing formal practices and institutions (North, 2005). Whether or not the governance of exchanges in emerging markets will evolve toward impersonal contract-based institutions is an ongoing debate. Some suggest that the governance of market exchanges should shift along with the economic growth from personal social to more impersonal economic exchange relationship (Peng, 2003). Others argue that such personal relational ties may continue to play a pivotal role to cope with uncertainties in these markets.

To address this debate, relational exchange perspective proposes that when trust and cooperation are associated with an exchange, the resulting shared norms and values may substitute for formal exchange mechanisms such as contracts and legal enforcement (Dyer & Singh, 1998). This perspective therefore implies that the formal contracts and relational governance may complement each other (Poppo & Zenger, 2002). This complementarity may be more salient in emerging markets where legal enforcement is weak and property rights protection is poor. Based on the context of cross-national relationships between foreign buyer and local supplier in emerging markets, this paper aims to discuss whether economic or social exchange logic well describes the governance of such relationship, and the implications for MNEs collaborating with local suppliers in these markets.

In particular, this paper addresses the following questions. First, under what circumstances and to what extent would MNEs rely more on formal institutions in terms of formal contracts and centralized control, than on informal institutions including personal relationships and trust to safeguard their transactions against opportunistic behaviors of local suppliers in emerging markets? Second, how should variations in legal enforceability of emerging markets affect the use of these formal and informal institutions? Third, as business transactions in emerging markets become more complex, would MNEs employ more informal institutions or more formal institutions over time to better safeguard their interests in emerging markets?

Economic and Social Exchange in the Relationship between Buyer and Supplier

Social exchanges include unspecified obligations and expectations of some future return when an individual does another party a favor (Blau, 1964). Because exchange parties are often unclear when and in what form they will receive a favor in return, trust plays an important role in social exchange relationships. Economic exchange relationships, in contrast, are often not long term and represent discrete and financially oriented interactions. Thus, buyer and supplier expectations about the exchange as narrowly defined and relatively short-term financially oriented, or more broadly defined and relatively long-term oriented transactions, is a critical distinction between economic and social exchange.

Opportunism is pivotal to the success of collaboration between buyer and supplier. Transaction cost economics defines opportunism as not only the explicit violations of terms stipulated in a contract, but also the lawful violations of implicit principles and rules in the contract or in the exchange relationship (Williamson, 1985). Opportunistic behaviors thus arise from both specified and unspecified areas in a contract. Asset specificity and uncertainty are main transactional characteristics that lead to such opportunistic behaviors (Williamson, 1985).

To safeguard against opportunism, the exchange partners usually draft detailed contracts specifying roles and procedures on their exchanges. However, such ex-ante contracts cannot specify all future contingencies (Williamson, 1985). Additional governance mechanisms are thus necessary to fill potential voids. While vertical integration is often not feasible, centralized control in the hands of the buyer may result in an effect similar to vertical integration in containing supplier opportunism (Bello & Gilliland, 1997). Centralized control represents a unilateral quasi-hierarchical structure rather than a bilateral, market-based arrangement. Besides, the enforcement of centralization depends on power asymmetry between parties rather than on external legal authorities (Heide, 2003; Zhou & Xu, 2012).

Apart from these formal governance mechanisms, exchanges are also coordinated through social relations and shared norms (Poppo & Zenger, 2002). This relational governance emphasizes cooperation and mutual trust between parties as a critical means to mitigate opportunism (Poppo & Zenger, 2002; Zhou et al., 2008). Such relationship-based structure builds a micro-level institutional framework to regulate behaviors of exchange parties (Williamson, 1985). Importantly, instead of relying on legal enforceability, the enforcement in relational governance is based on social norms such as flexibility, information sharing, and mutuality (Heide, 2003).

Institutional Perspective on the Governance of Buyer and Supplier Relationship

Institutional environment, organizations and constituents, and individuals with different behavioral preferences determine the comparative efficacy of governance choices in exchange relationships (North, 2005). Institutional environment includes rules and beliefs of socially acceptable behaviors while organizations and constituents articulate and impose rules or norms of legitimate behaviors. As markets become more developed, formal institutions are more effective in protecting property rights and mitigating risks inherent in market exchanges (North, 2005). Therefore, formal institutions which are based on laws and contracts will replace informal institutions such as personal relationships and trust when the market transitions toward a relatively well-established institutional environment.

In the early phase of institutional transitions when formal rule-based supporting institutions are not established, firms mostly rely on personal trust and informal agreements to cope with institutional uncertainties (Peng, 2003). When economic exchanges become more complex, firms often face an increased risk of opportunism arising from specialized assets and uncertainty. One party may hold up the other's relationship-specific investments to capture a larger portion of the rent (Williamson, 1985). The unanticipated changes resulting from incomplete and asymmetric information may also require the parties to adapt their operations and strategies (Krishnan et al., 2006). In the later phase when formal institutions become more established, formal impersonal institutions will become less costly to cope with these exchange risks. However, such transition is often difficult because social norms and personal ties are cultural heritage of human beings that requires fundamental reprogramming and supports of political, social, and economic institutions (North, 2005).

While the institutional logic suggest that firms rely more on informal social ties in the presence of weak institutions, transaction cost economics argue that more detailed formal contracts that specify the obligations of each party in an economic exchange are required in such situations to address increased transaction costs associated with unexpected events (Barthelemy & Quelin, 2006). In particular, such situations are associated with greater bounded reliability which increases transaction costs and thus undermines the efficiency of economic exchange (Verbeke & Greidanus, 2009). However, formal contracts are often not able to address all future contingencies. Because writing, monitoring, and enforcing contracts are not without costs, exchange parties can only specify contingencies that are associated with non-trivial risks (Poppo & Zenger, 2002).

Effects of Exchange Risks and Legal Enforceability on Governance Choices

Transaction cost economics identifies three major exchange risks including asset specificity, environmental uncertainty, and behavioral uncertainty. One party in the exchange may hold up the other to capture a larger portion of the quasi-rent derived from the investment in specialized assets (Williamson, 1985). Environmental uncertainty creates the need for parties to adjust operations and strategies in situations filled with incomplete and asymmetric information (Krishnan et al., 2006). Behavioral uncertainty occurs when performance of the exchange parties is difficult to measure. Parties therefore often specify explicit clauses to mitigate these risks.

The use of explicit contractual clauses to mitigate these exchange risks is however based on the assumption that laws are enforced in a consistent manner that creates the sufficient level of credibility, stability, and certainty (Peng, 2003). When legal enforceability is weak, firms may not be able to entirely rely on such detailed contracts. For example, firms are not confident that the courts will intervene on their behalf to divide the assets in an equitable manner if premature termination occurs in transaction-specific investments. Formal court procedures may not be able to resolve consequential disputes as a result of environmental uncertainty in an equitable or timely manner. Ineffective courts may also not be able to enforce the use of contractually specified remedies that address the behavioral uncertainty if the parties' performance is difficult to observe and measure.

Because emerging markets are categorized by the weak legal system, such enforceability problems are thus more pronounced in these markets. To cope with these challenges, foreign buyers may resort to relational governance to safeguard their interests against opportunistic partners. Relational governance is based on trusting beliefs that are developed from social-psychological bonds of norms, sentiments, and friendships as well as the faith in the morality and goodwill of others (Uzzi, 1997). It is characterized by the norms of proprietary information sharing, joint planning and operations, and commitments to work cooperatively (Zaheer & Venkatraman, 1995). Once such beliefs are established, the party has an expectation for how the other will act in the future. When facing uncertainty, firms will therefore turn to their trusted partners with prior experience in emerging markets for timely information-sharing and speedy coordination. This personal relationship not only enables the exchange of more detailed information, but also reduces information search costs.

Complementarity between Economic and Social Governance

In emerging markets, effective legal institutions do not automatically exist (North, 2005; Peng, 2003). Establishing and maintaining embedded social ties can facilitate economic exchanges, thereby reducing the need for costly contract negotiations (Uzzi, 1997). Such embedded ties also include reputation in one's social network which creates legitimacy that provides access to scarce resources in these markets (Sheng et al., 2011). Because of trust and reputation among parties in these social ties that reduces transaction costs of exchange, more costly formal controls become unnecessary (Dyer & Singh, 1998). Formal contracts are in fact useful in laying down general guidelines for the exchange. Without formal contracts, the partners would need to have some common history, location, or network, which are often lacking in the context of foreign buyers and local suppliers (Li et al., 2009). Social ties are more essential to facilitate the adaptation of contracts to future contingencies via mutual understanding, tolerance, and long-term orientation (Poppo & Zenger, 2002).

The effectiveness of contracts in curbing supplier opportunism in emerging markets depends on social relations among partners. Social obligations built on a shared identity in the relational governance bind parties together to assure contract execution (Uzzi, 1997). Under weak legal institutions in these markets, without relational foundation and shared norms, foreign buyers would incur not only higher costs of writing and executing detailed contracts but also greater losses from supplier opportunism. Relational governance thus functions as a proxy for voided legal institutions. The use of detailed contracts may instead impede trust and goodwill among exchange parties because it signals that the other party is not trustworthy (Ghoshal & Moran, 1996). Therefore, in emerging markets, complementarity between economic (e.g., detailed contracts) and social governance can effectively reduce local supplier opportunism (Zhou & Xu, 2012).

Relational governance is in fact costly because it requires creation and maintenance of personal connections through frequent interactions (Peng, 2003). Although exchange partners have established trusting beliefs, they may become opportunistic when the effective monitoring does not exist or when the exchange involves investments in specialized assets (Poppo et al., 2002). As legal enforceability improves, partners choose to employ less costly and more reliable explicit contracts to mitigate exchange hazards in terms of asset specificity, environmental uncertainty, and behavioral uncertainty (Zhou & Poppo, 2010).

To reduce supplier opportunism and enhance adaptations to future contingencies, foreign buyers may alternatively exercise centralized control when they possess more negotiation power (Heide, 2003). Centralized control is characterized by a unilateral and hierarchical structure (Bello & Gilliland, 1997), whereas relational governance is characterized by a bilateral and decentralized structure (Uzzi, 1997). The former requires efficient and impersonal interactions between partners, whereas the latter encourages mutual respect and voluntary information sharing (Boisot & Child, 1996). Centralized control relies on asymmetrical power to coordinate behaviors in the exchange, whereas relational governance fosters cooperation via social norms. However, the unilateral nature and asymmetric power structure of centralized control will be disrupted if used concurrently with relational governance. Therefore, in emerging markets, centralized control can effectively reduce local supplier opportunism when relational governance does not exist (Zhou & Xu, 2012).

In business practices, formal and informal mechanisms are used jointly (Dyer & Singh, 1998). Personal connections are a necessary precondition to more complex and risky exchanges in emerging markets (Boisot & Child, 1996). However, improved credibility of their legal system can also encourage parties to substitute such informal governance with more formal contracts (Peng, 2003). As legal enforceability in emerging markets increases, firms may not need much prior experience from their exchange partners to support the use of explicit contracts, thereby relying less on relational governance. On the other hand, when legal enforceability is still low, explicit contracts may support the use of relational governance by giving a sign of commitment to be a trustworthy partner (Woolthuis et al., 2005). The explicit contracts also strengthen the formalization of personal exchange which is characterized by the lack of the formal rules and expectations in such weak institutional context (Poppo & Zenger, 2002).

Illustrations of Relationship between Foreign Buyer and Local Supplier in China

The economic exchanges between foreign buyers and local suppliers in China well illustrate how MNEs minimize supplier opportunism in emerging markets. China is the second largest recipient of foreign direct investment with the largest number of foreign affiliates in the world. The country is an emerging market which is characterized by rapid economic development but volatile changes in social, legal, and economic institutions. Institutions governing interfirm relationships in China are also very much different from those in advanced markets. Particularly, formal institutions such as laws and regulations supporting market transactions in China are not well developed. Meanwhile, the use of informal institutions in terms of personal social relations is prevalent in business practices (Zhou & Poppo, 2010).

Despite the economic reforms since 1979, the Chinese government still retains strong control over the whole economy (Luo, 2007). In terms of legal reforms, since the first Economic Contract Law created in 1981 and a new contract law in 1999, the government has revised and implemented a series of law to provide a unified legal framework that addresses economic exchanges between domestic and foreign firms including technology cooperation and transfer. However, the government has not created a stable legal structure to effectively enforce contract law in the country. Legal enforcement is still subject to particularism and personal accommodation (Luo, 2007).

The lack of property rights protection, legitimate returns, and fair competition also creates significant strategic challenges for MNEs doing business in the country. Local government officials often accommodate the desires of companies that have established strong connections with them, thereby undermining the integrity of the legal system. Political ties with government officials are thus a critical resource for doing business in China (Peng & Luo, 2000). In less-developed geographic areas, the local governments often interfere with companies' business operations (Luo, 2007). Such interference makes political ties and connections with government officials become a critical factor in determining the success of doing business in these areas. Managers with fewer of such connections will perceive a lower level of legal enforceability. It is therefore not unusual for many companies to particularly designate a high-ranking executive as a boundary-spanner with the local or central government (Li et al., 2009).

Relational governance in China is well represented by the institutional norm of guanxi. The guanxi norm emphasizes interpersonal and interparty harmony (Peng & Luo, 2000; Xin & Pearce, 1996). It functions as a social lubricant in reducing transaction costs and fostering exchanges (Peng & Luo, 2000). Due to the lack of effective formal institutional structure, the enforcement of law is often subject to particularism and personal judgment (Zhou & Poppo, 2010). The guanxi norm in China is an important governance mode that fills the voids in formal legal institutions to deter opportunism (Xin & Pearce, 1996; Zhou et al., 2008). Violations of the guanxi norm will result in social sanctions including losing reputation and being excluded from the network of relationship. These sanctions are considered a serious punishment in Chinese society that emphasizes network legitimacy (Jones et al., 1997). The principles of guanxi norm in China also include the idea of maintaining an exchange partner's prestige, honor, and reputation. Entering in a detailed written contract assuming partner opportunism may be considered at odds in business practices and may instead result in negative consequences (Park & Luo, 2001).

Social ties and embedded trust in these ties have traditionally coordinated business exchanges in Chinese society (Peng & Luo, 2000; Xin & Pearce, 1996). Due to the weak legal supporting institutions and the lack of third-party verification of information, firms in China often resort to informal networks of trust-based relationship (Boisot & Child, 1996; Luo, 2007). When partners meet for the first time, they mostly rely on informal relationship building to initiate business transactions. Usually, only after gaining sufficient knowledge of the other through experience do they develop more formal exchanges through formal contracts. Risks are thus managed through these personal networks on the basis of accepted social norms rather than formal laws of contracts (Boisot & Child, 1996).

The prevalent social norm of personal connections and favors in China may not effectively support the use of contract law and contracts in China (Boisot & Child, 1996; Xin & Pearce, 1996). Therefore, as the formal institutions become more developed, a unique type of network capitalism emphasizing both legal contracts and long-term personal ties and trust would better characterize Chinese economy (Boisot & Child, 1996). Such hybrid governance institutions exist because it requires a fundamental change of cultural heritage of Chinese society to completely move from personal to impersonal exchange (North, 2005). Therefore, while the benefits of impersonal governance have increasingly emerged, personal social ties and trust still dominate in the business exchanges in China,

Discussion and Implications

In emerging economies, legal enforceability plays a critical role in determining the governance choice of interfirm relationships. Relational governance is better to safeguard transactions from exchange risks when legal enforceability is low while detailed contracts are a preferred choice when legal enforceability is high. However, among the three exchange risks (e.g., asset specificity, environmental uncertainty, and behavioral uncertainty) in emerging markets with weak legal enforceability, the risk from behavioral uncertainty may be difficult or unable to observe and avoid through both relational and contract governance. MNEs encountering such risk may consider using only contractual governance and only when the legal enforceability is strong, otherwise they should consider vertical integration (Verbeke & Greidanus, 2009).

Prior experience with the exchange partners is a precondition or social lubricant for establishing subsequent contractual exchange relationships in emerging markets. In particular, transacting with a known party when effective legal institutions do not exist provides a safeguard against economic and market risks and is an important step forward to greater detailed contracts. In the presence of weak legal enforceability, contracts convey a stronger signal of motives and commitment among exchange partners that strengthen the trusting beliefs. However, this effect declines when legal enforceability increases. When legal enforceability is strong, the detailed contracts instead convey an irritating signal. In particular, the contract may become a sign of coercion, sanctions, and distrust.

Social mechanism in terms of relational governance and economic mechanism in terms of detailed contracts and centralized control can jointly help MNEs mitigate local supplier opportunism in emerging markets. However, these mechanisms should be used in an appropriate combination. Detailed contracts are not effective in curbing supplier opportunism in emerging markets where legal institutions and enforcement are weak unless relational governance exists to provide a proxy for voided formal institutions. In particular, detailed contracts will reduce supplier opportunism when relational governance is high, but will deliver the opposite result when relational governance is low (Zhou & Xu, 2012). However, relational governance in emerging markets will become a liability for contingency adaptation in an authoritative organizational context. Specifically, centralized control will reduce supplier opportunism when relational governance is low, but will deliver the opposite result when relational governance is high (Zhou & Xu, 2012).

Detailed contracts may cause adverse consequences in emerging markets. The effectiveness of contracts will decline in the presence of noncontractable terms and weak legal enforcement (Zhou & Poppo, 2010). Social obligations and network legitimacy may remedy this contractual problem. However, if such social mechanism is also not available in the context of weak legal enforcement, detailed contracts may lead to even more opportunism as exchange parties may act entirely based on their interests. MNEs should also be cautious about the use of unilateral centralized control together with relational governance in emerging markets. While relational governance facilitates contract execution, it may also disrupt the unilateral ordering of centralization. Therefore, in the presence of this tradeoff, MNEs may consider to use pure unilateral authoritative control when they hold strong bargaining power over their local suppliers.

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