Available online at www.sciencedirect.com

SCIENCE DIRECT®

Industrial Marketing Management 33 (2004) 513–526

INDUSTRIAL MARKETING MANAGEMENT

NORTH-HOLLAND

Relationship marketing and contract theory

Sudhi Seshadri[a,*], Randhir Mishra[b]

[a]School of Business, Singapore Management University, Bukit Timah Road, Singapore
[b]Business Development, Satyam Computers, Hyderabad, India

Received 5 January 2004; accepted 8 March 2004

Abstract

The theoretical foundation of contracts and their limitations in governing exchange between firms is a current area of research in economics and business. The relationship marketing approach in business-to-business markets focuses on aspects in interfirm exchange that contracts cannot deal with efficiently. However, the ability to use contractual forms of governance where possible is crucial to the enhanced scope of relationship marketing management. We argue that contracts and relationships are complementary and that contracts provide an evolving governance structure for relationships. We examine the evolution of interfirm exchange theories in this framework and illustrate the convergence between contract theory and relationship marketing management, with examples from procurement in the supply chain, capacity reservation contracts, and program management.

Keywords: Relationship marketing; Contracts; Procurement; Program management

1. Introduction

At first glance, there is a polarity in thinking about markets and relationships. Markets and perfect competition characterize agents who cannot influence price in equilibrium. Yet, relationships require firms to modify their behaviors in an interactive manner to affect exchange. Markets exhibit spot contracts with few dimensions, and there is a pressure to further reduce the number of variables relevant to the contract. Relationships have several dimensions contingent on unknown events, and the parties consciously seek to increase the dimensions along which exchange occurs in the quest for new ways to create value. Markets are based on spot contracts that are theoretically first best on efficiency considerations. Relationships are long term, often noncontractual, and efficiency considerations are remote. Ever since Adam Smith and formal thinking on wealth-generating processes (Smith, 1776), business theory has acknowledged the centrality of markets, but has sought to develop the theory in ways that modify the perfect competition model to accommodate relational interactions. The theory of market equilibrium took a long time in the making by the measure of academic careers, and its literature is more than a hundred years old. The literatures both on contract and relationship marketing theories have developed more recently.

The first of these, the existing theory of contracts, is a departure from the perfect competition model. It explicitly acknowledges that agents interact through the price system, but also use a variety of formal and informal nonprice instruments and mechanisms to influence the decisions necessary for an efficient exchange between firms. Contracts are necessary to govern foreseeable and specific aspects of the exchange and are widely observed. They directly impact business performance. Considerations on financial returns, net of contracted expenses, drive practical transactions at the highest levels. While contracts may be explicit, there are also implicit and incomplete forms of contracting that lend themselves to longer term considerations. The second, the relationship marketing theory, is primarily concerned about this longer term. Relationships are necessary to transcend immediate and foreseeable economic concerns and are particularly important in situations of uncertainty and ambiguity. In such situations, future collaboration or termination is supported by implicit and explicit assumptions regarding the exchange (Dwyer, Schurr

* Corresponding author. Tel.: +65-6822-0751.
E-mail address: sudhi@smu.edu.sg (S. Seshadri).

0019-8501/$ – see front matter
doi:10.1016/j.indmarman.2004.03.004

and Oh, 1987). These may evolve as they are mediated by key behaviors in the relationship to influence the dynamics of outcomes (Morgan and Hunt, 1994). In fact, contracts may take on different forms over the course of the duration of the relationship between partners to the exchange.

Where does the transition between transactional and relational thinking occur? The two sides to the business exchange are not always on the same page, and mismatched expectations or approaches cause legal problems, often of major import. What terms of contracts are useful in relationships and what are purely transactional? More fundamentally, in the relationship marketing management approach, what should be left free of contracts; what should be contracted; and what would be the scope and choices among these contracts? We address these challenging questions here by arguing for the relevance of contract theory approaches to the relationship marketing theory. We will argue that contracts and relationships are complementary, and that contracts provide an evolving governance structure within which relationships themselves evolve. The paper develops the complementarities through a framework that links contract theory with relationship marketing for the mutual enrichment of theory.

We begin with a literature review of the concepts from the relationship marketing literature relevant to contract theory. The following section develops the integrated framework, and subsequent sections illustrate three extensions of short-term complete contract approaches that complement the relationship marketing literature. These illustrations are drawn from the capacity contracting, outsourcing, and information technology (IT) services domains and serve to provide concrete examples of how key dimensions that define contract theory could extend to relationship marketing. The concluding section identifies promising directions for future contract–relationship research.

2. Review and framework

Four parts make up this section. We trace the recognition in the marketing literature that relationships are finite and may be terminated. The inherent incompleteness in relationships that this engenders is the source of information and verifiability problems, leading to a variety of costs that have historically been viewed as contractual problems. We next trace the developments in contract theory, especially those that ensue from progressively longer term considerations, leading to considerations that historically have been associated with relationships. Finally, we propose a framework that links markets, contracts, and relationships.

2.1. Relationship continuity and termination

Marketing has been recognized as a process (Grönroos, 1995); and relationship marketing is seen as a continuous process involving inputs, outcomes, and continual assessment (Evans & Laskin, 1994). The advantages of relationship marketing can accrue to a firm if, and only if, the consumers are willing and able to engage in relationship patronage (Sheth & Parvatiyar, 1995). The underlying factors that emerge in the relationship research literature is that relationship continuity is an inherent and desired characteristic to achieve the benefits that a relational approach is expected to yield.

That time is inherent to the process was identified early with the most important characteristic of relational exchange that ‘‘it transpires over time’’ (Dwyer, Schurr, & Oh, 1987) and possesses a ‘‘long-term state’’ in stages of relationship development, where deliveries of continuously purchased product have occurred, wherein ‘‘companies will develop close relationships rather than play in the market, where they can obtain benefits in the form of cost reduction or increased revenues. These benefits are achieved by tailoring. . .durable investments’’ (Ford, 1980, p. 340). Clearly, a characteristic feature of a relationship is its duration over the long term, where the parties to the relationship depart from spot-market-determined exchanges.

But there is also recognition that relationships may be of finite duration, and that continuity is an ideal. Relationalism as ‘‘expectations of continuity of a relationship’’ leads to more relational exchanges, and ‘‘as the transactions become more relational, they occur over longer periods of time, and have less definite termination dates. . .’’ (Noordewier, John, & Nevin, 1990; p. 84). If a relationship yields rewards that fail to outweigh the costs, it would be dissolved (Dwyer et al., 1987); that is, as long as the relationship is productive, it would be continued. Low expectation of future exchange would be an outgrowth of current relational problems, whereas high expectations of future exchange would reflect a favorable perception of the current relationship (Crosby, Evans, & Cowles, 1990). Specific strategies will be necessary to assure relationship continuity. A set of relationship variables has been identified that impact continuation or termination of well-established and mature relationships, supporting the argument that relationship quality is the best predictor of the likelihood of future contact (Wilson, 1995). The likelihood of continuity in relationships is, therefore, not assured, and theories that link episode evaluation to the likelihood of relation continuity are recent areas of research (Mishra, 2001).

This line of inquiry draws upon the ‘‘behavioral concepts’’ of ‘‘contractual relations,’’ which are at the foundation of exchange relationships (Macneil, 1974). Contractual exchange behavior arguably involves relations that project exchange between parties into the future (Macneil, 1980). In effect, the relationship marketing literature has specifically identified the issue of continuity, with contracting as the governing modes of exchange. The possibility of a finite duration to a relationship makes it resemble a sequence of episodes, not unlike several shorter implicit contracts that link together, forming a longer term contract that is incomplete with regard to its termination.