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The impact of formal control and *guanxi* on task conflict in outsourcing relationships in China

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ABSTRACT

The purpose of this study is to explore how manufacturing firms manage task conflict with their outsourcing suppliers in the context of China. Using survey data collected from manufacturing firms operating in China, we found that when implementing R&D and manufacturing outsourcing, both formal control and Chinese *guanxi* are useful governance mechanisms for suppressing outsourcing task conflict. We also observe that Chinese *guanxi* moderates the impact of formal control on task conflict, especially when implementing R&D outsourcing. By investigating the roles of formal control and Chinese *guanxi* in outsourcing practices in China, this study contributes to a better understanding of how to manage task conflict effectively.

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1. Introduction

Manufacturing companies have increasingly recognized the potential to enhance their operational efficiency and innovation capability by mobilizing the knowledge and expertise of external organizations (Bengtsson, Von Haartman, & Dabhilkar, 2009). Moreover, in the increasingly networked economy, outsourcing has emerged as an important strategic tool for obtaining competitive advantage (Gottfredson, Puryear, & Phillips, 2005; Han & Bae, 2014; Kang, Wu, Hong, Park, & Park, 2014). When multinational manufacturers make decisions on outsourcing locations they primarily consider factors such as cost arbitrage, availability of skills and manpower, infrastructure and country risk (Graf & Mudambi, 2005; Linda Boardman, Paul, Amy, & Arthur, 2008; Pawar & Rogers, 2013). China scores very high on these criteria and subsequently has become one of the most attractive outsourcing destinations in the global economy (Wu, Wu, & Zhou, 2012). Outsourcing in China provides manufacturing companies various potential benefits, such as cost reduction, innovation capability enhancement, freedom to focus on core competencies and operational flexibility (Kang, Wu, Hong, & Park, 2012a). However, these benefits

are not guaranteed, as outsourcing in China also has various risk factors that threaten the success of the outsourcing relationship. Among these risk factors, outsourcing has the potential to lead to conflicts related to the transactions between the outsourcer firm and its suppliers (Lawler, Ford, & Blegen, 1988). Without proper handling of outsourcing conflict, especially in the highly relationship-oriented Chinese business culture, an outsourcer firm's long term orientation toward its suppliers might decrease, resulting in relational inefficiency, high transaction costs and disappointing performance (Lee & Dawes, 2005b).

However, despite the recognized importance of conflict management in the inter-organizational collaboration literature, few studies, if any, have explored outsourcing conflict management. In particular, it is still unclear how outsourcer firms avoid or mitigate outsourcing task conflicts with their suppliers. With the growing importance of China sourcing and China's relationship-oriented cultural characteristics, China is an appropriate and important context in which to investigate conflict management within outsourcing relationships. Thus, to address the research gap, this study investigates how manufacturing companies operating in China manage outsourcing task conflicts with their suppliers. More specifically, this study considers two specific types of governance mechanisms for managing outsourcing task conflict management: formal control and Chinese *guanxi*. From the governance perspective, both formal contracts and informal relational mechanisms are vital to reduce partners' opportunistic behavior and promote continuance of inter-organizational exchanges (Poppo & Zenger, 2002). Thus, it is reasonable to suggest that both formal control and Chinese *guanxi*

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may be useful governance mechanisms that have an important impact on the effectiveness of outsourcing task conflict management in the unique context of China. This paper also attempts to test how Chinese *guanxi* and formal control function as complements in managing outsourcing task conflict. In addition, recognizing that different types of outsourcing require different governance mechanisms for effective outsourcing practices (Kang et al., 2012a), we test our model by using two sub-samples, one representing R&D outsourcing and the other representing manufacturing outsourcing.

2. Theoretical background and hypothesis development

2.1. Formal control

Formal control mechanisms include formalized roles, job descriptions, clear goals and procedures in written format, through which firms can influence their partners to behave according to their specific requirements and thus achieve organizational goals (Das & Teng, 2001; Kirsch, Sambamurthy, Ko, & Purvis, 2002). Control studies highlight that formal control mechanisms are useful measures to mitigate uncertainties and partner's opportunistic behaviors, because they provide clear task and goal specifications and thus help reduce problems that could be caused by divergent views of tasks or goals (Das & Teng, 2001; Li, Xie, Teo, & Peng, 2010). If outsourcer firms fail to establish formal control mechanisms with their suppliers, they might be exposed to numerous outsourcing risk factors, such as the opportunistic behavior by the supplier, loss of core competence, increased dependence on suppliers, increased transaction costs, unnecessary conflicts and undesirable outsourcing performance (Kotabe, Mol, & Murray, 2008; Tibor, Oya Icmeli, & Walter, 2006). Outsourcing by nature entrusts tasks to external suppliers through contracts, and thus it is very important to clearly specify the requirements in order to reduce outsourcing risks and increase outsourcing benefits.

However, excessive use of formal control mechanisms could potentially undermine trust and long-term collaboration (Christ, Sedatole, Towry, & Thomas, 2008). To address this threat, Kang, Wu, and Park (2012b) in their case study emphasize that outsourcer firms need to focus their exercise of formal control on the key processes related with outsourcing performance (i.e., quality and delivery) in order to effectively reduce performance risks and relational risks. This is in contrast to attempting to exercise broad control over all outsourcing practices. In this study, when we refer to formal control we do not refer to hierarchical oversight of suppliers in general, but rather refer to focused formal control applied specifically to the key processes that ensure clarity in outsourcing goals, such as quality and delivery terms, or clarify task specifications to avoid suppliers' self-serving interpretations or opportunistic behaviors. Different types of outsourcing may require formal control over different key processes to ensure desired outsourcing performance. For example, when outsourcing garment manufacturing, inspection of received raw materials may be a key process for ensuring outsourcing quality. In addition, clarifying outsourcing goals in written format and implementing outsourcing based on detailed task specifications are generally recognized as important formal control practices in achieving desired outsourcing performance (Chen, Park, & Newbury, 2009; Das & Teng, 2001). With the high level of uncertainty in transient economies such as China, such formal control usage may be essential for reducing conflict with partners and enabling long-term outsourcing success (Kang et al., 2012a). Therefore, formal control is incorporated into the research model as an important formal governance mechanism that is expected to reduce task conflict in outsourcing relationships.

2.2. Chinese *guanxi*

Chinese *guanxi* is a special Chinese-style relational network rooted in traditional Chinese culture (Park & Luo, 2001), and is regarded as a

source of sustainable competitive advantage for firms that do business in China (Cheng, Yip, & Yeung, 2012). Chinese *guanxi* is characterized by favor exchange and mutual obligation (Chen, Huang, & Sternquist, 2011b). In the literature, Chinese *guanxi* is defined as "an informal, particularistic personal connection between two individuals who are bounded by an implicit psychological contract to follow the social norm of *guanxi* such as maintaining a long-term relationship, mutual commitment, loyalty, and obligation" (Chen & Chen, 2004). One of the key differences between Chinese *guanxi* and general relationship management is believed to be their guiding principles. According to Wang (2007), general relationship management is guided by legality and rules, whereas Chinese *guanxi* is driven by morality and social norms.

China is known as a relationship-based society. In Chinese culture, informal personal relationships play critical roles in inter-organizational transactions, and can directly and indirectly influence the business performance of transacting parties (Xin & Pearce, 1996). Chinese *guanxi*, as a unique type of informal personal relationship in traditional Chinese culture, is believed to have the power to influence social norms as well as business norms (Wong, 2007; Zhai, Lindorff, & Cooper, 2013). Chinese people take advantage of *guanxi* in all aspects of their lives, including their political and economic lives. It is a useful source of market information (Lee & Humphreys, 2007), and has a determinant position in negotiation processes (Davies, Leung, Luk, & Wong, 1995). An outsourcer firm operating in China also needs to develop *guanxi* with its supplier. Without having a *guanxi* connection between the outsourcer and the supplier, the two parties are not closely bound by a relationship of mutual trust and favor exchange, and each party is free to pursue its own benefit. When a supplier has multiple customers, it treats each customer differently according to the *guanxi* it has with that customer. In times of crisis, the outsourcer firm that has good *guanxi* with the supplier will be treated as a preferred customer (Trent & Zacharia, 2012). Given the importance of *guanxi* in business practices in China (Chen, Ellinger, & Tian, 2011a; Lee & Humphreys, 2007; Su & James, 2001), its role in buyer-supplier relationships in the China context cannot be neglected. Moreover, the concept of *guanxi* is associated with economic and favor exchanges, and also is based on mutual trust and long-term tendency, and thus a deeper *guanxi* relationship implicitly denotes obligation, guarantee, and understanding. (Chen & Chen, 2004).

2.3. Task conflict

Conflict refers to "a process in which one party perceives that its interests are being opposed or negatively affected by another party" (Wall, 1995). This study focuses on inter-organizational conflict that occurs between buyer and supplier within an outsourcing relationship (DeChurch & Marks, 2001). More specifically, conflict in this study refers to task conflict that occurs because of disagreements over how to implement outsourcing tasks. Such disagreements could be related to differences in viewpoints, ideas or opinions between an outsourcer firm and its supplier (Jehn, 1995). In an exchange relationship, conflict is often inevitable between exchange partners (Gaski, 1984; Lusch, 1976b; Rosenberg & Stern, 1971), because of the inherent conflict of interest embedded in the very act of exchange (Mallen, 1963). Conflict is potentially disruptive to efficiency and performance in a channel of distribution (Lusch, 1976a; Rosenberg & Stern, 1971) and overshadows the cumulative effects of cooperative channel behaviors (Palmatier, Dant, Grewal, & Evans, 2006). Without proper management, it can prevent the buyer and supplier from understanding or adopting each other's viewpoints, ideas or opinions, and may result in the buyer or supplier withdrawing resources from the pursuit of joint business goals, or restricting or distorting flows of information (Brown, 1983). In the marketing channels and buyer-supplier relationship literature, research shows that conflict has a negative effect on exchange partner satisfaction and on operating performance (Dwyer, 1980; Frazier, Gill, & Kale, 1989; Lusch, 1976a; Rosenberg & Stern, 1971; Wilkinson, 1981). Given

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