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Formal governance mechanisms, relational governance mechanisms, and transaction-specific investments in supplier–manufacturer relationships

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Abstract

This study addresses the question of how to design governance mechanisms so that local suppliers are encouraged to make transaction-specific investments in foreign manufacturing firms. Suppliers' transaction-specific investments can increase the efficiency of production for foreign manufacturing firms operating in a host country. However, it can be difficult to induce suppliers to make specialized investments, because of the numerous hazards associated with such investments. Basing its conclusions on the results of a survey of Taiwanese firms using Chinese suppliers, this study examines the effectiveness of both formal governance mechanisms (i.e., contractual agreements and financial commitments) and relational governance mechanisms (i.e., calculative and benevolent trust) in inducing suppliers to make specialized investments. We find that both formal governance and relational governance mechanisms affect suppliers' tendencies to make specialized investments. Additionally, we find that calculative trust acts as a moderating factor in the relationship between formal governance mechanisms and transaction-specific investments.

Keywords: Formal governance mechanisms; Relational governance mechanisms; Transaction-specific investments; Supplier–manufacturer relationships

1. Introduction

Manufacturing firms making foreign direct investments cannot simply enter a foreign country and commence the effortless exercise of their proprietary advantages (Buckley & Casson, 1976). Rather, to enhance their ability to compete, they must work at the complex and sometimes delicate task of establishing cooperative relationships with suppliers in host countries (Dyer, 1996). When local suppliers make transaction-specific investments in manufacturing firms—showing their willingness to cooperate with these firms—the overall efficiency of production is improved.

Transaction-specific investments are those investments intended to support a specific manufacturer—supplier relationship. For example, a supplier might invest in specialized tools or equipment to produce customized or idiosyncratic components for a manufacturing firm. However, transaction-specific investments are not without cost for suppliers; that is, transforming these investments into other relationships of similar value can be tricky. If a manufacturing firm chose to terminate such a cooperative relationship, a supplier could very well incur an irrevocable loss, owing to the difficulty of recouping the loss of its investments. The purpose of this study is to explore the factors which induce a supplier to make transaction-specific investments, thus satisfying the needs of the relevant manufacturing firm.

In most transaction cost economics (TCE) research (i.e. Williamson, 1985), the characteristics of transaction-specific investments have been examined in light of their impact on governance mechanisms; that is, transaction-specific invest-

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ments are treated as an exogenous variable (e.g., Heide & John, 1990; Joskow, 1987). The major proposition, along this line, is that manufacturing firms are asked to offer contracts to safeguard suppliers' specialized investments. When contracts cannot provide the necessary safeguards, manufacturing firms are forced to engage in vertical integration to mitigate suppliers' lock-in hazards. In practice, however, given that transaction-specific investments are necessary, many transactions exist outside the realm of vertical integration or contracts (Bensaou & Anderson, 1999). Bensaou and Anderson (1999) postulated that one possible reason for this is that relationships based on trust lessen the chance that vertical integration will be used to protect transaction-specific investments. An ongoing relationship generally fosters trust and enables partners to adopt more flexible models of cooperation (such as alliances), create value together (that is, mutual benefits or reciprocity), and, eventually, induce suppliers to make transaction-specific investments.

Over the last decade, researchers have begun to examine the impact of governance mechanisms on the value-creation initiatives of exchange partners (Claro, Hagelaar, & Omta, 2003; Zajac & Olsen, 1993). However, the conditions that enable transaction-specific investments have received less attention. Recently, Bensaou and Anderson (1999) argued that architectural interdependence, complexity, the thinness of the supplier market, and the scope of a relationship all influence automakers to make specialized investments in suppliers. Following this line of research, this study took suppliers as the sample body from which to further explore whether formal or relational governance mechanisms induce suppliers to make transaction-specific investments.

According to the TCE perspective, the numerous hazards to suppliers require the drawing up of explicit legal contracts or an agreement upon specific financial recourse (Williamson, 1985). As a demonstration of goodwill, as well as to reduce the exchange hazards faced by suppliers, manufacturing firms may, as a matter of course, need to provide contracts or financial commitments to suppliers. However, the TCE seems to overemphasize the use of explicit contractual safeguards in potentially hazardous exchange settings (Dyer & Singh, 1998; Poppo & Zenger, 2002).

The relational perspective offers a different, less explicit set of governance mechanisms, such as trust, to persuade suppliers to more willingly make transaction-specific investments. Relational governance in this study refers to interfirm exchanges that include significant relationship-specific assets, combined with a high level of interorganizational trust (Zaheer & Venkatraman, 1995). Indeed, the presence of trust has been described as an important antecedent to interfirm cooperation (Smith, Carroll, & Ashford, 1995).

It remains unclear, however, what sort of a trade-off exists between relational governance mechanisms (such as trust) and formal governance mechanisms (such as contracts and financial commitments). Some researchers have examined whether relational governance functions as a substitute for complex, explicit contracts (Bradach & Eccles, 1989; Dyer & Singh, 1998). To our knowledge, few researchers have explored the relationship between relational governance mechanisms and formal governance mechanisms by examining the specialized investments made by suppliers in their foreign-manufacturer clients. We hope to shed some light on the subject.

A particular institutional environment may encourage or impede the building of relational ties between trading partners (North, 1990). Chinese society has functioned as a highly relational network of clans since the sixth century BC, and therefore provides a context appropriate for the examination of the impact of trust on transactions (Park & Luo, 2001). Because China is currently the world's largest recipient of foreign direct investment (FDI), we have chosen to examine the impact of formal and relational governance mechanisms on Chinese suppliers' making specialized investments in foreign (i.e. Taiwanese) manufacturing firms. In any part of the world, however, we believe it is critical to understand how to construct governance mechanisms that will improve cooperation between foreign and local firms.

The purpose of this study is to provide insight into how suppliers might be induced to make specialized investments in manufacturing firms. In this vein, we offer several contributions to the governance-mechanism literature. First, we take the transaction-specific investment as an endogenous variable and then examine whether formal governance mechanisms and relational governance mechanisms induce a supplier's transaction-specific investment. Second, we evaluate the substitutive relationship between formal governance mechanisms and relational governance mechanisms on transaction-specific investments made by manufacturing firms. Third, we adopt a specific measurement for specialized investments [i.e., "molds," as defined by Random House's Webster's College Dictionary (2000) as a hollow form for giving a particular shape to something in a molten or plastic state], thereby reducing ambiguity related to the question of whether or not specialized investments may have alternative uses. Fourth, this study focuses in particular on firms operating in China, allowing the observation of the special institutional context effect. Finally, we provide some suggestions for foreign manufacturing firms to help them create cooperative relationships with local suppliers in China.

2. Literature review

2.1. Transaction cost economics perspective

To protect themselves against various hazards of exchange, cooperative partners may employ a variety of