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Contractual and Relational Governances: Are they Complementary or Substitutable in the Context of Value Chains

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Abstract
Interactions among value chain actors can be governed either through contractual or relational governance mechanisms or through the use of both at the same time. The question of complementarity or substitutability of these two governance mechanisms has already attracted the attentions of researchers nowadays. This essay is the review of selected scientific journals in the area of contractual and relational governance mechanisms. The purpose is to compile the research findings in a way it assists readers to better understand whether contractual and relational governance mechanisms are complementary or substitutable.
Keywords: contractual governance, relational governance, complementary, substitutability

1. Introduction

Nowadays, researchers have started giving attention to the impacts of both contracts and social relations on value chains management and research in this area are on a rise. Some researchers support the complementarity of the two mechanisms while others suggest their substitutability. Depending on the specific purpose for or context under which the value chain actors use these governance mechanisms, their complementarity or substitutability may vary.

For instance, Wang et al (2011) studied whether the two mechanisms are complementary or substitutable from the point of view of innovation performance of the value chain actors and their finding showed that the relational approach (trust) promotes innovativeness of the value chain actors while contractual mechanism (contracts) reduces it. For them, using detailed contracts leads to rigidity and can be interpreted as distrust between the actors. In this case, contracts are considered as redundant and even counter effective when employed together with relational mechanism.

On the other hand there are researchers who suggested complementarity of the two mechanisms. For instance Liu et al (2009) said contractual governance is effective in restraining opportunistic behaviors of value chain actors while relational governance improves their relationships. These researchers argue that both curbing opportunistic behaviors of value chain actors and at the same time improving relationships lead to better overall value chains' performance. Relational governance is viewed as filler of holes that are left open by contractual governance and vice versa as both mechanisms do have limitations. Hence, they are complementary.

Therefore, this review article attempts to compile what have been suggested by various researchers regarding complementarity or substitutability of the two governance mechanisms so as to assist readers to better understand how the two mechanisms work under various contexts and purposes.

Methodology

As indicated in the introductory part, the aim of this review work is to draw clear understanding as to the complementarity or substitutability of contractual and relational governance mechanisms from what has been published in this area. After identifying the topic for review, relevant journal articles were searched online using Google scholar search engine and e-journals search engines available in the Ghent University library by typing "contractual and relational governances" as key words. Dissertations, textbooks, and unpublished working papers, and conference proceedings papers have been excluded for the rigorousness of the review. Though the search has resulted in many published papers, based on the relevance and the available time for the review work, only 15 journal articles were selected and used for this work. Even if the selection was done randomly, it happened that the selected 15 journal articles were published on 15 different journals (i.e. one for each). The fact that the journal articles are selected from different reputable journals makes the review more comprehensive. The list of journals and the number of articles from each of those journals are presented in the following table.

Table 1: The articles resources-journals

No.	Title of the journal	Number of articles	Analysis model used
1	Journal of Academy of Marketing Science	1	Principal component analysis
2	British Food Journal	1	Binomial logit model
3	Acta Sociologica	1	Descriptive review
4	Food policy	1	Descriptive analysis
5	Journal of Marketing Research	1	Structural equation model
6	Journal of Operations Management	1	Multivariate regression and semi-partial correlation
7	Harvard Business Review	1	Descriptive review
8	Strategic Management Journal	1	Structural equation model (three stage least square)
9	Journal of Industrial Management and Data Systems	1	Descriptive review
10	International Journal of Research in Marketing	1	Descriptive review
11	Journal of Industrial Marketing Management	1	Case study method
12	Administrative science Quarterly	1	Grounded theory building
13	Journal of Operations Management	1	Ordinary least square (OLS)
14	International Journal of Production Economics	1	Structural equation model (partial least square)
15	Journal of Marketing	1	Structured equation model (partial least square)

2. What is relational governance?

It is a governance mechanism that emphasizes on inherent and moral control used to govern exchange processes through the establishment of consistent and cooperative atmosphere (Liu et al, 2009). It is often based on trust, respect, friendship and reciprocity that result from repeated and healthy interaction between value chain actors over long time. These constructs of relational governance reduce exchange difficulties and enhances collaboration within the relationship (Villena et al. 2011).

Social scientists like Granovetter (1992) focus more on a broader concept of social capital which is a valuable asset obtained through accessing resources made available for parties in the relationship. The social capital has three dimensions. These are: (1) the cognitive dimension that deals with the extent to which culture and goals are shared; (2) the relational dimension which looks at trust, friendship, respect and reciprocity building between value chain actors; and (3) the structural dimension that refers to the creation of social ties between value chain actors. Social capital builds relational attachment that reduces the likelihood of conflicts to arise between the value chain actors and promotes cooperative behavior because of its association with the shared vision, trustful relations and strong social ties (Villena et al, 2011).

There are several reasons why relational governance is based on trust rather than on contracts. Value chain actors generally face few problems with their chain partners (suppliers and customers) when they build good working relation and personal connections. This fact naturally encourages the value chain actors to continue doing business with each other through trust than contracts (Roxenhalla and Ghauri, 2004). When chain actors are involved in a long-term and closer relationship through frequent interactions, they are subjected to less opportunism from partners and thus substitute relational rules for written contracts (Jia and Huang, 2011)

In order to neutralize the negative perceptions against value chain partners, it is vital to build trust (Sahay, 2003). In order to develop trust, chain actors need to share values and render dependable service level to each other. Nowadays, trust is seen as one of the most important factors for establishing and sustaining successful value chains. The primary outcome of governance through trust is the access for use it provides to privileged and difficult-to-price assets owned by others for competitiveness which is unlikely to happen under contractual governance due to its inflexibility (Uzzi, 1997).

The mismatch between words and actions of a value chain partner could likely lead to deterioration of trust (Sahay, 2003). Whereas, sharing information that is vital for the relationship leads to trust building as it makes other partner to feel secured in the relationship. Trust can also develop from positive interpretation and assessment results of value chain partner’s motive in the relationship. Trust can also be transferred from one partner to another when trusted partner witnesses the trustworthiness of the other (a buyer or a seller).

3. Favorable aspects of relational governance

Some researchers held a view that favors the use of relational governance due to its importance and they argue that it has even diminished the relevance of contractual governance. For instance, Poppo and Zenger (2002) state that there is only little need for value chain actors to contractually specify their future actions once they built trust in each other. Relational governance also plays a key role in lowering transaction costs and in establishing smooth interaction between value chain actors.

Relational mechanism can be more effective and efficient than contractual mechanism in situations where value chain actors have the capacity to understand their respective duties, benefits and responsibilities as stipulated in the aligned plans, policies and strategies (Liu et al, 2009). Uzzi (1997) argues that relational governance mechanism creates economic opportunities that are difficult to replicate through contractual governance mechanism. Once value chain actors create the desire to preserve the relationship, the desire itself makes the actors to act in a way beneficial to all (Nayaranan and Raman, 2004).

Relational governance out performs contractual governance in curtailing the complexity of risky situations by providing a structure by which resources owned by one value chain actor can be made available to others for use (Uzzi, 1997). According to Poppo and Zenger (2002) as relational governance mechanism establishes trust and collaborative behavior, value chain actors can be flexible and easily cope up with inevitable environmental uncertainties.

The use of relational governance mechanism better encourages value chain actors to engage in wide range of value creation activities and it helps the actors to easily adapt to the volatile exchange environment (Liu et al, 2009). The high level of trust, reciprocity and cooperative resource sharing behavior of the value chain actors under relational governance can also generate investment capacities that cannot be achieved through contractual tie due to the fact that the latter focuses on short-term gains (Uzzi, 1997). Relational governance aims at the creation of an environment in which value chain partners can stand together during bad and good times.

Relational governance may promote the refinement of the terms of formal contracts. The lessons learnt, the information shared, and the experience gained from interactions during prior period of relationships can be used for revising terms of contracts (Poppo and Zenger, 2002).

4. Limitations of relational governance

The synergies that emerge from the accumulated relational social capital improves performance up to the point where increases in risk and costs offset benefits and then performance starts to diminish (Villena et al, 2011). As social capital increases, value chain actors' performance increases initially and gradually slows down and eventually bottoms out when value chain actors start to think alike and the risks of inflexibility increase. This happens because of reasons like (1) chain actors become more reluctant to switch to other better performing partner due to the strong attachments, (2) chain actors lose timely and accurate feedback due to negligence emanating from closeness, (3) too much information exchange creates information overload leading to confusion and delay in decisions.

When conflicts arise between value chain actors, no matter how long they have been in relationship with each other, the terms of their informal agreement may be denied by either of the value chain actors in the contract at the court of law. Hence, conflicts may be handled unfairly in the absence of written contracts which serve as primary tools for conflict handling (Ferguson et al, 2005).

Value chain actors should not underestimate the effect of excess level of relationships and the need to find ways of reducing it so that it would not move beyond the point of turn around (Villena et al 2011). Excessive amount of trust may lead to reduced monitoring, evaluation and safeguarding efforts by chain actors to a level that may encourage actors' malfeasance. Under such condition value chain actors are less motivated to put maximum efforts into the achievement of the shared goals as they reach the stage of complacence.

Sheng et al (2006) pointed out that the effectiveness of relational governance erodes under hazardous exchange environment caused by future uncertainties. Under such situations, value chain actors might be defaulted from doing their share of responsibilities in the relationship unless there are some legal instruments to compel the fulfillment of the requirements by chain actor.

5. Contractual governance

Contracts govern exchanges between value chain actors by avoiding uncertainties through legal stipulations (Liu et al, 2009). Contracts state the rights and obligations of both parties through formal rules, terms and procedures; and also explicitly explain how various future situations are handled.

Roxenhalla and Ghauri (2004) have identified three main reasons for drawing contracts. These are: (1) contracts can be used as evidences during conflict resolution, (2) contracts control the parties to perform what are stipulated therein, and (3) contracts serve as tools to explain and interpret vague aspects of agreements.

Contracts can be assessed in terms of contract type, contract amount, contract extent, nature of the information contained, and signatories (Roxenhalla and Ghauni, 2004). The contract type refers to the unilateral- or joint-formulation; contract amount refers to the total monetary amount a buyer pays to the seller for the exchange transaction; contract extent explains the volume/pages of the document; the nature of information refers to the technical, administrative and commercial components of the content; and signatories refer to names and positions of individuals to sign the contract.

The value chain environment, the degree of closeness of the chain actors, and type of products and services exchanged are considered to determine whether to use contracts and what type of contracts to formulate if they are to be used (Roxenhalla and Ghauri, 2004). In an environment where future events are very difficult to forecast, comprehensive contracts that address every aspects of the possible outcomes have to be drafted. When the chain actors are much closer to each other, contracts do not need to be that comprehensive. In situations where the exchanged product/service are difficult to measure, contracts have to be much more detailed to protect the high risk of opportunism.

Longer contract negotiations may be very likely to result in increased closeness as value chain actors become more familiar with each other during the negotiation process (Roxenhalla and Ghauri, 2004). Still depending on matters given emphasis during negotiation process, the development of closer relationship between the chain actors could be enhanced or hindered. If the discussion capitalizes on issue of relational characters instead of focusing on control, the negotiation could most likely end up in establishing closeness between the value chain actors.

6. Strong sides of contractual governance

Contractual governance is superior to relational governance in offering a formal framework through which joint decisions are made, collective actions are taken, and conflicts are resolved (Liu et al, 2009). At the early stage of the exchange process, formal contracts help ensure better performance than trust which needs longer time to develop (Poppo and Zenger, 2002).

Careful negotiation improves the effectiveness of contracts to build relationships between value chain actors (Ferguson et al, 2005). Poppo and Zenger (2002) indicated the possibility of creating highly cooperative relationships between value chain actors through the use of contracts that provide frameworks for bilateral adjustments instead of contracts that only specify deliverable outcomes. This shows the outstanding role contracts can play in enhancing relationships if they are carefully designed.

7. Limitations of contractual governance

Though contract is expected to reduce transaction costs for the value chain actors during its term through legal enforcement, on the other hand, it entails other types of costs, namely ex-ante contract costs such as costs of contact drafting, negotiation, and safeguarding the terms of the contract and ex-post costs of contract enforcement (Jia and Huang, 2011).

Most of the time, the use of formal contracts as governance mechanism is perceived as a way of exercising power by the less dependent and more powerful value chain actors on the highly dependent one (Ferguson et al, 2005). The formers always go for highly explicit contracts to maximize their own benefits from the relationship. This creates dissatisfaction on the later actors and trigger them to behave opportunistically. This approach is opposite to the win-win strategy and threatens the profitability of the individual value chain actors and of the value chain as a whole in the future.

Contractual mechanisms limit value chain actors' motivation to do beyond what the call of the contracts to overcome substantial deficiencies and unexpected contingencies that may occur after contracts are signed (Liu et al, 2009). Though contracts are the best tools to curtail opportunistic behavior, a failure to specify all elements of the interactions could rather motivate partners to cheat (Wuyts and Geyskens, 2005). Moreover, contracts do emphasize on control through legal enforcement which may signal distrust between chain actors and rather encourage opportunism (John, 1984).

Value chain actors with high risk taking behavior are prone to draft formal contracts while operating in uncertainty environment (Wang et al, 2011; Wuyts and Geyskens, 2005). For such actors contracts would limit opportunities that new and uncertain future situations bring.

8. Discussions: Complementarity or Substitutability?

Before addressing the question of complementarity or substitutability of the two governance mechanisms, it is important to know for what purposes or under what contexts value chain actors want to sign contracts or to build relationships (see table 2 for detail of purposes and contexts). It could be to improve both operational and financial performances, to prevent themselves from opportunistic behavior, to raise additional funds for long-term investment, to avoid risks resulting from uncertain outcomes or else to enhance innovativeness etc. For instance, Ferguson et al. (2005) approached the question of complementarity or substitutability of the two governance mechanisms from the point of view of performance achievement in terms of customer satisfaction, overall service quality improvement, positive word of mouth and enhanced future purchase intentions. Liu et al (2009), on the other hand, addressed the question from the point of view of value chain actors with the aim of curbing opportunistic behavior of partners. Wang et al (2011) treated the same question from innovativeness angle.

Poppo and Zenger (2002) assessed the importance of contractual and relational governance mechanisms from the directions of asset specificity, measurement problem and uncertainty with respect to future outcomes and concluded that the use of one mechanism fulfills the deficiency of the other. In hazardous situations, simultaneous use of contractual and relational governance mechanisms leads to better performance as additional benefits emerge from the configuration of contractual clauses and relational norms and trust (Liu et al, 2009; Wuyts and Geyskens, 2005). But the findings of the research by Sheng et al. (2006) showed the ineffectiveness of relational governance mechanism under uncertain exchange environment and proposed the substitution of contractual governance mechanism for it. Poppo and Zenger (2002), on the other hand, indicated complementarity rather than substitutability of the two governance mechanisms under such situations as the use of one mechanism enhances the completeness of the other.

It is then clear as to how the degree of environmental uncertainty determines the effectiveness of each governance mechanism and also how it dictates the decision to either substitute or complement the mechanisms. There is a need for strong legal environment and framework to obtain the best out of the use of contractual mechanism which may lack in situations where the legal system is not yet well developed (Wang et al. 2011).

According to Liu et al (2009) the contractual mechanism is relatively more effective in curbing opportunistic behavior of value chain actors while relational governance is more effective in enhancing sales volume, market share, discounts, and marketing support. Hence, they suggest complementarity of the mechanisms as in order to mitigate opportunism and achieve the desired outcomes.

In some situations, it is difficult to measure the quality of product/service exchanged and that makes the use of contractual mechanism as measurement problem constrains the contract contents. For instance, it would be very difficult to measure the quality of grains filled in a sack as an opportunistic farmer can put quality grains only on the top-layer of the sack after filling the sack with poor quality grain. Most buyers judge the quality of the grain by looking only at a sample taken from the top as the middle or bottom layers are inaccessible in situations where technology is not available. Under such condition, it is hardly possible to use contracts, hence it is advisable go for closer relationship with the farmer (i.e. relational governance is preferable to contracts under such situation).

The research by Wuyts and Geyskens (2005) indicates that combining contractual and relational governance mechanisms increases opportunism and they rather suggest the use of contracts alone in the absence of prior relationships. Wang et al (2011) have also confirmed the same view saying contracts are important at early stage of partnership on the basis of which trust develops gradually. It is always strange to trust a buyer or seller little is known about. All exchange activities with such a buyer or a seller must be undertaken only after contracting. But with repeated interactions and proven good character of the buyer or the seller, trust and the feeling of friendship grow and reach a stage where the parties do not need formal contracts to govern their relationship.

The sufficiency of one governance mechanism to satisfy the exchange needs of the value chain actors in a highly volatile economic environment without one being complemented with the other is doubtful (Liu et al, 2009; Uzzi B. 1997). The findings of the research by Ferguson et al (2005) shows that the use of sufficient relational norms mitigates any substantial negative consequences of contractual governance. This finding goes in line with complementarity of the two governance mechanisms. When value chain actors work with purposes of satisfying their customers through improved product and service qualities, the use of both governance mechanisms (complementarity) is recommended because both mechanisms are believed to positively contribute towards these purposes (Ferguson et al, 2005).

In case of value chains where there is power imbalance between the actors (i.e. when the powerful actor can say more than the less powerful one), the powerful actor may not show willingness to collaborate with the less powerful one. Rather the powerful actor prefers to go for contractual mechanism (Wuyts and Geyskens, 2005) with an assumption that personal interest can better be maximized. The powerful actor believes more in power than in relationship with the powerless actor in the chain. Hence, power imbalance calls for substitution of contractual mechanism in most of the cases, though exceptions are always there.

As indicated earlier, conflict resolution can serve as the base for choosing between complementarity and substitutability of the two mechanisms. As Ferguson et al. (2005) indicated relational mechanism is ineffective in situations where there are conflicts as it is very difficult to prove the roles played by the actors while they were in relations due to absence of any written evidence (i.e. contract). On the other hand, Roxenhalla and Ghauni (2004) argue the other way round mentioning the rare use of contracts in connection with conflicts. Whenever conflicts arise between actors, they rather resolve informally without resorting to contracts or without involving

legal professionals.
However, relational governance mechanism is more appropriate to achieve better innovation performance than contractual mechanism as it is practically difficult to specify terms and clauses that can fully capture the creative and unpredictable aspects of innovation inputs and outcomes in advance (Wang et al, 2011). The use of relational governance mechanism better encourages value chain actors to engage in wider range of value creation activities and it helps the actors to easily adapt to the volatile exchange environment (Liu et al, 2009). Similarly, when all the value chain actors (parties exchanging) believe in collectivism rather than individualism i.e. when everyone focuses on group goals rather than individual-goals, there is no need for contracts to govern exchanges (Wuyts and Geyskens, 2005).
In the following table important points have been drawn from the discussions part and summary of purposes for or contexts under which value chain actors should either complement or substitute the two mechanisms and suggestions made by different authors have been presented.

Table 2: Classification of the available literature on complementarity and substitutability

	Base for classification	**References in favor of either of the two or both**
1.	Power-imbalance among value chain actors	Substitutable-contracts for relations (Wuyts and Geyskens, 2005)
2.	Customer satisfaction through quality improvement	Complement- use both (Ferguson et al, 2005)
3.	Uncertain and risky economic environment	1. Complement-use both (Liu et al, 2009; Poppo and Zenger, 2002; Uzzi, 1997) 2. Substitute-relations for contract (Wang et al, 2011; Wuyts and Geyskens, 2005) 3. Substitute- comprehensive contract for relations (Sheng et al, 2006; Roxenhalla and Ghauri, 2004)
4.	Existence of collaborative culture	Substitute-relations for contracts (Wuyts and Geyskens, 2005)
5.	New interaction (new partnership)	Substitute-contracts for relations (Jia and Huang, 2011; Roxenhalla and Ghauri, 2004; Wang et al, 2011; Wuyts and Geyskens, 2005)
6.	Need for additional investment capacity	Substitution-relations for contracts (Uzzi, 1997)
7.	Innovativeness of value chain actors	Substitute-relations for contracts (Liu et al, 2009; Wang et al, 2011)
8.	Prevalence of opportunistic behavior	Substitute –exhaustive contracts for relations (Liu et al, 2009; Wuyts and Geyskens, 2005)
9.	Absence of strong legal system	Substitute-relations for contracts (Wang et al, 2011)
10.	Likelihood of conflicts	Substitute-relations for contracts (Roxenhalla and Ghauni, 2004) Substitute-contracts for relations (Ferguson et al. 2005)

One of the important lessons learnt from this review work is that contractual and relational governance mechanisms can be complemented or substituted based on the purpose for or context under which the value chain actors want the governance mechanisms (i.e. do they want to increase customer satisfaction, minimize opportunism, enhance innovativeness, resolve conflicts etc). Otherwise, it is impossible to blindly recommend either complementarity or substitutability of the two mechanisms. Hence value chain actors need first to analyze the prioritized what they need to maximize after the decision of choosing between substitution and complementing. Under the wider scope of purposes and contexts complementarity is preferable to substitutability as strong sides of one mechanism neutralize the limitations of the other.
The other important point to note from this work is that in all the papers reviewed the costs aspect of using these governance mechanisms was given less emphasis. If the cost factor is seriously taken into account, it could be possible to make more comprehensive and concrete recommendations to the value chain actors regarding the complementarity or substitutability of the two mechanisms.

9. Conclusions

The question as to which governance mechanism should be used for an effective value chain management under different purposes/contexts has already attracted the interests of researchers attempts have being made to look for answers. Though most of the research findings suggested that the combined use of contractual and relational mechanisms works better, there are also researchers recommending substitution. From the review work, it was clearly understood that both mechanisms have got their own strong and weak sides with respect to purposes/contexts under consideration.

Relational governance mechanism is based on trust, friendship, respect and reciprocity building between value chain actors. It normally requires repeated interactions of the actors for these relational constructs to develop. Once developed, they serve as a glue to sustain fruitful relations between value chain actors. Contracts, on the other hand, are written legal instruments that clarify the detailed rights and obligations of the value chain actors (contracting parties) involved through formal rules, procedures, terms, etc.; provide explanations as to how the actors should do their share of duties; and at the same time establish control on the actors to perform their duties as stipulated in the contract. Moreover, contracts can also be source of solutions to conflicts that arise between the contracting parties.

The decision to either complement or substitute the two governance mechanisms should be based on contexts such as certain vis-à-vis uncertain environment, collaborative vis-à-vis individualistic culture, opportunism vis-à-vis trustworthiness, new vis-à-vis old relationship, balanced vis-à-vis unbalanced powers, innovativeness vis-à-vis stagnancy, existence of strong legal system vis-à-vis weak/absence legal system, etc. that are included in analysis models of the reviewed papers. Findings of this review show the use of bother mechanisms lead to better achievements under some purpose/contexts while substitution of one mechanism for the other is better under some other.

In general, the systematic way of using one governance mechanism can rather enhance the effectiveness of the other. Transparent and exhaustive contractual negotiation and designing of bilateral contracts could strengthen the level of trust between value chain actors and lower opportunism. On the other hand, the establishment of good relationship among value chain actors encourages value chain actors to have smooth interactions that lead to high concern for the interest of the other party which in turn results in further refinement of terms of contracts.

10. Future research direction

With specific reference to the selected papers for this review work, I can say that the question of complementarity or substitutability of contractual and relational governance mechanisms was addressed only from the point of views of limited contexts. Still further research need to be done even in the same contexts to better support and crystallize the findings of previous research as clarity is still lacking and sufficient empirical evidences are required. In some of the cases, there are also contradictions of the findings even on the same context. Moreover, other contexts/dimensions of the relationships must also be taken up to fully address the question of complementarity or substitutability of the two governance mechanisms. Attempts need to be made to get an answer to the same question from the point of view of efforts and costs required under each mechanism as these variables are also very important to consider while making such a decision.

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