

Chapter 7

Value Creation and Appropriation in Buyer– Supplier Relationships: Governance, Competition and Cultures

Wiboon Kittilaksanawong
Saitama University, Japan

ABSTRACT

The productive relationship between buyer and supplier is often subject to opportunistic behaviors of the supplier. When selecting a supplier, firms have to balance between benefits of production efficiency and costs of transactional integrity. To minimize the supplier's opportunism, firms devise formal and informal governance mechanisms that match with characteristics of the relationship at the firm level, sourcing strategy of the buyer, at the industry level, competition among suppliers, and at the country level, national culture where the supplier's operations are located. While concurrently employing both formal and informal governance mechanisms may be more effective in suppressing the supplier's opportunism, it may be too costly in the design and implementation. The best strategy for the buyers is to adopt the governance mechanism that matches with characteristics of the relationship at different levels.

INTRODUCTION

The productive relationship between buyer and supplier in terms of contract manufacturing or outsourcing has become a prevalent business model that potentially offers substantial benefits to organizations. However, such relationship is often subject to self-serving behaviors of the supplier to the detriment of the buyer. When selecting a supplier, firms must determine how much value will be created from that supplier, and how that value will be divided between the firm and the supplier (Obloj & Zemsky, 2015). Firms may not achieve competitive advantage based solely on production efficiency of their supplier. They have to evaluate, among other attributes, the integrity of their supplier. Firms may use supplier integrity, a costly contractual hazard as a criterion in selecting their suppliers or relocating their sourcing

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activities accordingly. The tradeoff between benefits of production efficiency and costs of contracting is therefore critical in determining performance of the productive relationship (Poppo & Zenger, 2002).

Supplier opportunism including self-serving behaviors is typically a critical element in determining overall costs of contracting (Heide, Kumar, & Wathne, 2014). To influence ongoing decisions of the supplier in such a way that minimizes its potential opportunism, firms often rely on specific formal and informal governance mechanisms. The formal mechanisms include monitoring, while the informal ones include relational norms (Gulati & Singh, 1998). The buyer's ability to monitor and suppress opportunism is however contingent on characteristics of the exchange including sourcing strategies (Heide et al., 2014). In the context of contract manufacturing, firms often have to make a choice between in-house production (e.g., 'make' decision) and outsourcing to independent suppliers (e.g., 'buy' decision). In some circumstances, firms rely on concurrent external sourcing and internal manufacturing for the same product (Parmigiani, 2007). These different sourcing strategies will determine the degree to which the buyer is able to suppress the supplier's opportunism via specific governance mechanisms such as monitoring and relational norms.

In addition to such firm-level sourcing strategies, industry-level characteristics of the exchange in terms of supplier competition also determine the extent to which the buyer can suppress the supplier's opportunism. Competition among suppliers reduces their surplus from producing general-purpose products for the buyer. The buyer may, therefore, be in a stronger bargaining position to demand the supplier to invest in relationship-specific assets that produce higher-value customized products without sufficient reciprocal commitment (Jia, 2013; Kang, Mahoney, & Tan, 2009; Kittilaksanawong, 2015). Such relationship-specific investments would lose at least part of their value if the buyer terminates the relationship early. This threat may allow the buyer to discourage the supplier from engaging in any opportunistic activities that reduce performance of the productive relationship.

When the productive relationship is extended across national boundaries, changes in country-level characteristics of the exchange in terms of institutional environment may alter the effectiveness of governance mechanisms in the productive relationship (Williamson, 1991). The governance costs associated with the use of formal and informal governance mechanisms to suppress the supplier's opportunism in purely domestic contexts may be very much different when the productive relationship extends across national boundaries with the complicating influence of national culture (Handley & Angst, 2015; Poppo & Zenger, 2002).

This chapter discusses the challenges in the buyer and supplier relationship and highlights recommendations for scholars to deepen knowledge in this area and for managers to optimize the value in productive relationships with their suppliers. The chapter begins with the balance between production efficiency and costs of contracting. Due to this tradeoff, the chapter then explains the importance of aligning governance mechanisms (e.g., formal and informal mechanisms) with characteristics of the productive relationship (e.g., sourcing strategies, supplier competition, and national cultures) to suppress the supplier's opportunism and to optimize benefits from the exchange. The subsequent sections discuss in a greater depth on the influence of firm-level sourcing strategy, industry-level supplier competition, and country-level national culture on such alignment. The last section provides implications for scholars and managers involving in this important buyer and supplier relationship.

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