

**Relational Contracts in China:
Relational Governance and Contractual Assurance**

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Abstract

What enforces contracts in emerging economies such as China, in which the legal system is weak, yet the use of contracts is still prevalent? We offer that relational governance, a social institution, provides contractual assurance. We develop this perspective and empirically examine whether relational governance functions as a substitute for, or supplement to, weak formal enforcement—the courts—and thus promotes the use of contracts in China. Our findings broadly support this perspective: increasing levels of uncertainty and asset specificity are met with higher levels of relational governance, which in turn promotes greater contract customization.

Countries with a strong legal system have courts to enforce contractual provisions. Interestingly, in emerging economies such as China, in which the legal system is weak, the use of contracts is still prevalent (Zhou et al., 2003). Existing perspectives offer different views on the use of contracts. For example, conventional institutional analysis suggests that emerging economies will transition from personal connections to rule-based institutions that support impersonal market exchanges—a necessary transition, as inefficiencies arise in the use of social institutions to govern large-scale and complex market transactions as compared to the use of more-formal institutions (North, 1990: 34-35; 1992: 6; see also Li, Park, and Li, 2003, and Peng, 2003). Relatedly, the efficiency logic of transaction cost economics indicates that for market exchanges, contracts mitigate some of the inefficiencies that arise from exchange hazards, namely asset specificity and uncertainty (Williamson, 1996). Others, however, counter that social institutions, which have governed exchanges in China through norms and obligations for thousands of years, impede a reliance on, the development of, and the use of formal institutions such as a legal system and contract law with its efficiency-based logic for coordinating exchange (Boisot and Child, 1996; Child, Chung, and Davies, 2003; Xin and Pearce, 1996; Yang, 1994). Thus, according to this view, it is somewhat surprising that the use of contracts is still prevalent in China.

While informative, the above perspectives do not adequately explain what enforces the use of contracts in China, given the weak property-rights protection of the legal system at this time. In this paper, we develop a logic that integrates aspects of the alternative views offered above. We posit that complex contracts in China are enforced by a social institution—relational governance. That is, they are relational contracts: customized contracts that enjoy the support of relational governance (MacNeil, 1978). Relational governance is a social institution that governs

and guides exchange partners so they behave in a mutually beneficial and supportive fashion based on a common understanding of cooperative norms and collaborative activities (Macneil, 1980; Noordewier, John, and Nevin, 1990; Heide and John, 1992; Poppo and Zenger, 2002).

Our perspective is that relational governance may function as a substitute for, or supplement to, weak legal enforcement—the courts—and thus furthers the use of contracts to govern exchanges. We advance that managers seek greater levels of relational governance in response to exchange hazards and that greater levels of relational governance promote greater contract customization. This path to the use of contracts is distinct from that which exists in countries with strong legal systems, in which managers select greater contract customization in response to exchange hazards (Williamson, 1991; Joskow, 1988; Poppo and Zenger, 2002). We propose that managers may be willing to customize contracts because relational governance gives them some assurance that both parties will honor the formal agreement and its intent—an important governance capability when managers cannot rely on courts to enforce contract law. Relational practices further enforce the use of contracts as a framework for adaptation. Through the exchange of information, involved parties are likely to have better information about each other than any third party when adapting to unexpected changes. Relatedly, joint practices and solidarity norms foster a bilateral orientation to problem-solving that further supports the use of contracts as a framework for bilateral rather than self-interested adaptation (MacNeil, 1978).

Consistent with our logic, recent works suggest that social institutions play an important role in coordinating exchanges in emerging economies. These works emphasize that the use of prior ties and connections reduces the uncertainty associated with behavioral intentions. For example, the use of prior ties decreases perceptions of economic exchange risk (Xin and Pearce, 1996, McMillan and Woodruff, 1999; Johnson, McMillan, and Woodruff, 2002) and sanctions

the search for “new” partners, especially in times of uncertainty (Nee, 1992; Keister, 1999; Luo, 2002; Zhou et al., 2003). In addition, embedded networks can further sanction economic exchange if parties punish behavior in the event of a breach of contract (Greif, 1993). Thus, our framework extends this conventional view of social ties in emerging economies by considering the role of another kind of social institution, relational governance; its direct relationship with the use of formal contracts; and an efficiency (e.g., transaction cost) explanation for its emergence.

Prior studies have also examined whether trust or relational governance complements or substitutes for formal contracts in technologically intensive partnerships (Larson, 1992), geographically constrained industries (Uzzi, 1997), or the outsourcing of information technology (Poppo and Zenger, 2002). In this study, we contribute to this literature by considering the relationship between relational governance and contracts in a different institutional environment: emerging economies with weak legal systems. Moreover, while the proposition that relational governance emerges in response to exchange hazards is established in the literature, empirical support for it is mixed (Brown, Dev, and Lee, 2000; Poppo and Zenger, 2002; Rindfleisch and Heide, 1997; Sheng et al. 2005). In this aspect, our paper enriches the literature by examining an institutional setting in which an extension of the transaction cost logic may be more appropriate. Finally, our focus on the hybrid governance alternative of relational contracts informs and contributes to the debate identified earlier on the role of formal and social institutions in emerging economies (e.g., Boisot and Child, 1996; North, 1990; Peng, 2003).

THE CONVENTIONAL VIEW OF CONTRACTUAL ENFORCEMENT

According to transaction cost economics, efficient governance results from matching governance structures, which vary in their effectiveness, with exchanges, which differ in their attributes (Williamson, 1991). Central to this logic is that exchange hazards, namely uncertainty

and asset specificity, trigger the potential for self-interested behavior, which undermines the efficiency of economic exchange. For example, when the buyer makes co-specialized investments, the investments are specific to the seller and cannot be redeployed for other uses in the event that the exchange relationship terminates prematurely. In this situation, the seller may behave opportunistically to capture a larger portion of the quasi-rent associated with the specialized investment. In addition, uncertainty is likely to escalate the transaction costs associated with specialized investments because adaptations of the exchange may be complicated by strategic bargaining and posturing. The parties may for example “operate at cross-purposes,” “read and react to signals differently,” or “behave strategically—by distorting information or disclosing it in an incomplete and selective fashion” (Williamson, 1991: 278).

Transaction cost economics predicts that as exchanges become more hazardous, managers craft more-complex contracts, neo-classical contracts, in an effort to deter one partner from strategically exploiting the other for self-gain (Williamson, 1991). Neo-classical contracts contain particular clauses that specify processes and procedures to facilitate coordination with unexpected changes. Thus, they function as a framework for adaptation by specifying a “tolerance zone within which misalignments will be absorbed,” “information disclosure and substantiation if adaptation is proposed,” and arbitration if adaptation fails (Williamson, 1996: 96). While these contracts are not necessarily complete, and gap-filling occurs, they can mitigate opportunism by providing a framework for guiding adaptation. This kind of flexibility is not found in more-simple contracts, classical contracts, because clauses focus on the terms of trade, imply no dependency between the buyer and supplier, and thus engender no need for identity (e.g., a social relation between the two parties) (Williamson, 1996: 95). Accordingly, empirical

work shows that managers generally rely on more-complex contracts as asset specificity increases (Joskow, 1988; Poppo and Zenger, 2002).

A critical assumption underlying this conventional logic is that the institutional environment supports a legal system that protects property rights in even the most simple contractual agreements (North and Weingast, 1989). An effective legal system also encourages parties to undertake risky, specific investments—should unresolvable differences exist and premature termination occur, the courts will intercede to divide the assets in an equitable manner (Williamson, 1991). Directly applying this logic to China, however, is problematic because, despite the continued institutional reform since 1979, the government has not created a stable legal structure to enforce contract law. Rather, enforcement is subject to particularism and personal accommodation (Boisot and Child, 1996). For example, Child and Mollering (2003: 72) state that the high levels of “inconsistency, arbitrariness, and corruption on the part of officials” severely interfere with business operations. Case studies also describe the inconsistent enforcement of contract law and the lack of property-rights protection: in particular, local governments often dismiss contract law when conflict arises and, instead, accommodate the desires of companies with strong political connections (Li, 2004). Empirical work also shows that Chinese businesses profit from strong political ties with government officials, presumably because government officials personally accommodate their needs (Peng and Luo, 2000).

When laws are not enforced in a consistent manner, but are subject to particular circumstances, legal institutions do not create the level of stability and certainty required to support contracts (North, 1990). Based on the literature, we do not believe that managers choose greater levels of contract customization in response to exchange hazards. Nor do we formally

hypothesize the alternative—that exchange hazards trigger greater levels of contract customization. Yet our empirical model specification acknowledges this possibility.

THE GOVERNANCE CHOICE OF RELATIONAL CONTRACTS

Relational Governance and Contractual Assurance

We offer an alternative governance choice, relational contracts, in which relational governance may substitute for, or supplement, weak legal enforcement and thus promote the use of contracts. Our argument is twofold. First, if relational governance sanctions exchange behavior and therefore minimizes transactional risk, then managers should choose greater levels of relational governance, not contracts, in response to greater levels of asset specificity and uncertainty. Second, since more-hazardous exchanges benefit from a formal specification of the terms, conditions, intent, and mutually agreed-upon procedures for adapting to unexpected changes, managers will select greater levels of contract customization in response to greater levels of relational governance. They are willing to further customize the contract because relational governance gives them some assurance that both parties will honor the formal agreement and/or its intent. Figure 1 illustrates our conceptual model.

Insert Figure 1 about here.

Many endorse an efficiency-based logic to explain the antecedents to relational governance: as exchange hazards increase, amplifying the potential for opportunistic behavior, managers increasingly turn to relational governance to attenuate such behavior (Heide and John, 1992; Noordewier, John, and Nevin, 1990; Poppo and Zenger, 2002). That is, managers select greater levels of relational governance in response to exchange hazards because it can mitigate

transaction costs arising from premature termination, misappropriation of the quasi-rent associated with specialized investments, and costs arising from adaptation.

Relational governance sanctions self-interested behavior in a number of ways. Social obligations, such as those arising from a verbal handshake, enforce compliance with relational norms and practices (Macaulay, 1963; Uzzi, 1997). Others also suggest that parties are motivated to comply with normative practices because they benefit from the fulfillment of basic social needs, such as belonging or dependency (Uzzi, 1997; Granovetter, 1992).

Relationally governed exchanges may also rely on the most straightforward punishment to enforce its use—refusal to deal with a trading partner in the future and/or driving the partner out of the network. This mechanism is likely to be highly effective because establishing and maintaining one's network reputation is critical in uncertain environments such as transition economies (Johnson, McMillan, and Woodruff, 2002: 229; Peng and Luo, 2000; Zhou et al., 2003). Research further indicates that network membership offers legitimacy and therefore helps businesses secure access to capital as well as commerce, since network membership influences partner selection (Nee, 1992; Keister, 2001). Thus, parties act in a cooperative, trustworthy manner to preserve their market reputation (Hill, 1990).

Relational governance may further sanction behavior because the norms and business practices serve as a requisite safeguard, since parties must commit sizeable investments to develop these bilateral, potentially value-added practices (Madhok and Tallman, 1998; Dyer, 1997). Given the high level of termination costs, parties are less inclined to be opportunistic. Accordingly, the high cost of terminating the relationship must be compared to its value, which depends on expectations of future exchanges—that is, cooperation in the present depends on the payoffs, either economic or social in nature, from continued exchange (Parkhe, 1993; Poppo and

Zenger, 2002). Thus, expectations of continuance generally characterize relationally governed exchanges (MacNeil, 1978).

Regardless of the precise motivation to cooperate, a central feature of relationally governed exchanges is that parties will act in the future according to normative conventions even in the presence of uncertainty and asset specificity. Such behavioral reliability, a form of trust, enables partners to act as if the expected value of the exchange is stable (Luhmann, 1979; Lewicki and Bunker, 1996), leading to cooperative rather than opportunistic behavior. Relatedly, because information exchange is a central feature of relational governance, it can offset opportunistic behavior or inefficiencies that can plague adaptation in market exchanges. In China, where information flow is largely local and private, both parties' broader networks of business connections may provide information that facilitates joint planning and thus adaptation to uncertainty (Boisot and Child, 1996; Li, Park, and Li, 2003). Moreover, without access to business practices that provide an opportunity for fine-grained information transfer and monitoring, assessing each party's contribution would be difficult and provide an opportunity for strategic negotiations over the quasi-rent associated with specialized assets (Heide and John, 1992). Thus, sharing of cost information as well as proprietary information can mitigate opportunism arising from opportunities to strategically misrepresent information. Joint action through close operational coordination and solidarity norms also enables parties to project exchange into the future when resolving conflict from adaptation pressures and to ideally maximize the joint value of the exchange (Palay, 1984; Heide and John, 1990). Thus, relational governance promotes coordinated adaptation, the most difficult and costly problem for hybrid forms of organization (Williamson, 1991).

We propose that when considering this governance choice, managers match exchange hazards to the costs of building relational governance. Since parties must commit sizeable investments to develop these bilateral practices and norms, they will do so only for high levels of transactional risk, that is, when exchange hazards are high. Empirical works, though few in number, provide mixed support for the logic that as exchange hazards increase, managers select greater levels of relational governance. Some find a positive association between asset specificity and relational governance (e.g., Anderson and Weitz, 1992; Heide and John, 1990), whereas others do not (e.g., Poppo and Zenger, 2002; Sheng et al., 2005). Given our institutional context, we suspect:

H1: The higher the exchange hazards, the higher the degree of relational governance.

We argue that in emerging economies that lack an effective court system, relational governance may further safeguard exchanges characterized by uncertainty and specialized assets by combining its use with formal contracts. While these exchange hazards threaten exchange efficiency through self-interested behavior, which often occurs during adaptation (Williamson, 1991), we advance that relational governance in conjunction with contracts may further mitigate problems of self-interested action through coordinated adaptation. Most notably, contracts function as a framework for adaptation. The framework formalizes lessons that are learned from prior periods—implementing procedures and processes that better facilitate adaptation (Poppo and Zenger, 2002; Mayer and Argyres, 2004)—and such routines benefit from their codification in order to preserve and extend these practices into the future. Moreover, because localized, specific knowledge disappears when specific individuals change jobs, formalizing operating procedures may also be necessary to preserve and improve their efficient use (Stinchcombe, 1990; Ring and Van de Ven, 1994). Codification may also provide parties with greater enforcement

capabilities, which would seem especially critical as their businesses grow in scale and scope, given the potential limits of social institutions to enforce large-scale, large-scope transactions (North, 1990; Peng, 2003).

Although promises to cooperate may provide some level of contractual assurance, relationally governed exchanges provide further contractual assurance through the exchange of private information. According to transaction cost economics, accessing private information in market exchanges makes adaptation problematic, even when contracts exist (Williamson, 1991). Yet because of the close coordination of operations between the buyer and supplier, parties can more easily evaluate the accuracy of the exchanged information, thus resulting in the exchange of high-quality information that is requested by contractual provisions. In fact, compared to the use of a legal system to resolve disputes, information disclosure is likely to be better under relationally governed exchanges. Thus, information exchange supports the use of contractually specified procedures and processes aimed at mitigating disputes and inequity in the event of unexpected changes.

Similarly, norms of solidarity in contrast to self-interest further support contractual intent and the use of formally specified promises or obligations to perform particular actions in the future (Macneil, 1978). For instance, a bilateral orientation to conflict resolution sanctions parties' taking an unfair position due to their bargaining power, which would otherwise lead them to depart from contractual intent and the use of contractually specified provisions. Moreover, reciprocity norms may foster contractual intent by minimizing the interval in which adaptation occurs. For example, if a negotiated outcome favors one party, rather than delay continuation of the exchange through excessive conflict and bargaining due to a self-interested orientation, parties can simply proceed, knowing that the exchange of favors will be equitable in

the long run. Relatedly, since parties in China cannot rely on the courts to allocate assets if the conflict should escalate to the point of premature termination, flexibility in negotiated outcomes, such as that created through reciprocity norms, is especially critical for promoting continuance of the exchange.

Though our logic that relational governance promotes contractual assurance in economies with weak legal institutions is distinct, recent empirical work *indirectly* supports the idea that social institutions are necessary to support the use of contracts. Partners who are meeting for the first time rely on informal contracts to initiate business transactions in China; only after time has passed and trust-based relationships are in place will parties use formal provisions to coordinate exchange (Zhou et al. 2003: 93). Thus, trust evolves first, contracts second. Empirical work also endorses the complementary use and performance benefits of relational governance and contracts in economies with effective legal institutions (Poppo and Zenger, 2002). Relatedly, over time contracts become more complex as they integrate more-effective procedures for coordinating the exchange, presumably ones that have been recently learned (Mayer and Argyres, 2004).

In sum, if relational governance provides contractual assurance, we expect that as hazards increase, companies develop greater levels of relational governance, which in turn promotes greater customization of the contract. We hypothesize the later relationship below.

H2: The greater the level of relational governance, the higher the level of contract customization.

Relational Governance and Contracts as Substitutes

Our position that contracts and relational governance function as complements is different from the commonly held argument that relational governance supports economic exchange without the added cost of increased contract customization (Dyer and Singh, 1998; Gulati, 1995; Uzzi, 1997; Adler, 2001). Many scholars argue that the use of contracts declines as

a function of the increasing use of relational governance. In particular, business relations tend to be more formal initially, relying on the contract to resolve conflict and dispute, and over time resort to more-informal means to resolve any conflict (Larson, 1992; Uzzi, 1997). These studies infer that informal norms and practices supplant the need for greater customization of the contracts and therefore economize on transaction costs by decreasing the need to amend the contract over time (Dyer and Singh, 1998). Trust develops in these relationships through reliance on the socially sanctioned norms and practices that define relational governance. Formal contracts may also be detrimental to exchanges employing relational governance, as they may signal distrust of the exchange party (Ghosal and Moran, 1996) or crowd out intrinsic motivation (Osterloh and Frey, 2000). Thus, these arguments suggest that relational governance substitutes for contracts.

A similar substitution perspective exists in the Chinese literature as well: rule-based governance is unlikely to emerge because of the tradition of using social relations to sanction economic exchange (Boisot and Child, 1996; Xin and Pearce, 1996; Li, Park, and Li, 2003). Because legal reform has not been codified into stable rules, Chinese businesses use trust-based relationships that rely on interpersonal accommodation—functioning through relational governance—to settle disputes and changes and to safeguard or protect their business needs (Gernet, 1982; Boisot and Child, 1996). Moreover, because legal enforcement is unreliable and third-party verification of information is not available, distrust of not only rules, but also public information, arises. Since the traditions of one contraindicate those necessary to support the other, relational governance is not compatible with the use of contracts. For instance, Boisot and Child (1996: 625) explain that whereas the Western system continues to be based on legal contract and ownership rights, the emergent Chinese economy is based on long-term trust

relationships—network capitalism. If both emerge, Li et al. (2004: 72) caution: “The incompatibility of the two systems causes confusion and corruption, and thus the possibility of deteriorating the rule of law.”

While this substitution perspective is hardly new, empirical work is rare in China. Using interview data, Xin and Pearce (1996) find that private businesses rely more on personal ties than state-run or hybrid (jointly private and state-owned) businesses. They infer that the reason is that privately held firms have less access to stable legal institutions than state-run and hybrid businesses. However, this empirical work is inconsistent with more-recent work that shows the broad use of contracts independent of the ownership status of the players (Zhou et al., 2003). If personal ties substitute for formal institutions, why do state-owned, foreign, hybrid, and privately held firms behave similarly in their choice of contractual forms and provisions?

This “either-or” position thus offers a different explanation of the relationship between relational governance and contracts in China. If relational governance and contract law are incompatible, then relational governance plays no facilitating function. Instead, relational governance will decrease the reliance on contracts, which we hypothesize below.

H2alt: The greater the level of relational governance, the lower the level of contract customization.

Long-Standing Ties as a Determinant of Relational Governance

In China, buyer-supplier ties are often embedded in a decentralized network of long-standing business groups among local government, businesses, and the requisite buyers, suppliers, or partners (Peng and Luo, 2000; Keister, 1999). Studies of Chinese businesses reveal that social connections within these groups usually underlie the selection of new exchange partners (Nee, 1992) and that when they do, they result in significantly stronger levels of business activity than selection among strangers (Keister, 1999). This is not surprising, because

transactions among groups of known reputation reduce uncertainty—parties will not risk damaging their reputation through self-interested, opportunistic actions (Granovetter, 1985). Empirical work further shows that entrenched business connections promote a reliance on the same exchange partner, even when more-competitive alternatives exist (Keister, 2001), potentially erecting an entry barrier to firms that lack social connections or, more simply, creating market inefficiencies.

Although buyers and suppliers in China typically approach one another through social connections, we suspect that these ties are unlikely to demonstrate high levels of relational governance initially. The accumulation of experiences over time, based on observation of each others' responses and actions in a variety of situations, is necessary to develop entrusting norms (Blau, 1964; Rempel, Holmes, and Zanna, 1985; Lewicki and Bunker, 1996). Similarly, we proffer that personal experience with one another precedes the development of cooperative norms and practices aimed at improving coordination. With little personal history to count on, parties are reluctant to make significant investment in relational norms and practices such as information disclosure and close collaboration. The uncertainty toward their partner's motives, intents, and competences makes such actions exceedingly risky, and, relatedly, vulnerability arises if they disclose or commit too much, too quickly.

Over time, however, both parties gain confidence in the other from their observations and interactions in a variety of contexts. This confidence is referred to as knowledge-based trust, which exists when “when one has enough information about others to understand them and accurately predict their likely behavior” (Lewicki and Bunker, 1996:119; Blau, 1964). Similarly, Gulati (1995: 92) explains how previous experience facilitates the development of norms: “The idea of trust emerging from prior contact is based on the premise that through ongoing

interaction, firms learn about each other and develop trust around norms of equity.” As trust develops, it enables the formation of close social relationships between the two parties, especially as compared to the ideal type of arms-length transactions (Uzzi, 1997). Consistent with this logic, Poppo and Zenger (2002) find that long-standing business relationships lead to greater levels of relational governance. Empirical work further finds that managers in emerging economies rely on their own assessment of the supplier’s reliability and connection to a business network when those managers seek to guard against self-interested behavior while extending trade credit (McMillan and Woodruff, 1999; see also Johnson, McMillan, and Woodruff, 2002), suggesting that prior ties help sanction behavior. We thus hypothesize:

H3: The longer parties have done business together, the higher the degree of relational governance.

METHOD

Sampling and Data Collection

To test the hypotheses, we examined buyer-supplier relationships for manufacturing firms located in two major areas (Beijing and Shanghai) in China in 2004, which is the largest emerging economy at this time. These two areas represent the fastest-growing regions during China’s transition toward a market economy (Luo, 2002; Zhou et al., 2003), hence offering a rich context to test our model of governance choices in an emerging economy. We collaborated with local researchers to have trained interviewers carry out the survey through on-site personal interviews, as this is a key means of obtaining reliable and valid information in emerging economies (Hoskisson et al., 2000: 258).

We first developed an English version of the questionnaire that independent translators rendered in Chinese with back translation to ensure conceptual equivalence (Hoskisson et al., 2000). To further ensure content and face validity of the measures, we conducted five in-depth

interviews with senior purchasing managers in which each respondent was asked to check the relevance and completeness of the measures. Based on their responses, a small number of questionnaire items were revised to enhance their clarity. Then, we conducted a pilot study with 40 purchasing professionals in which the respondents were requested not only to answer all the items but also to provide their feedback on the design and wording of the questionnaire. We then finalized the questionnaire based on the results of the pilot study.

A sample of 1,000 firms was randomly selected from a list of all manufacturing firms located in the two areas in the four-digit Chinese Industrial Classification (CIC) codes 1311 ~ 4290, which are similar to Standard Industrial Classification codes (but with slight variations). These firms spanned diversified industries (e.g., electronics, computer equipment, chemicals, transportation equipment, apparel, furniture, food, and plastics). In each firm, a senior purchasing manager was chosen as the key informant because our interviews revealed that these managers were most knowledgeable about their relationships with suppliers.

Managers were first contacted by telephone to solicit their cooperation. To motivate them to participate, we informed them of the academic nature of this study and the confidentiality of their responses, as well as offered an incentive in the form of a summary report. A total of 476 managers from different firms agreed to participate. Then, 403 were successfully interviewed on-site. Informants were first asked to select one of their firm's major suppliers and then answer the survey questions regarding their exchanges with the chosen supplier. After eliminating four surveys with excessive missing data, we obtained 399 complete responses, representing an effective response rate of 39.9% (399 out of 1,000 firms). The majority of the firms (64.1%) had from 100 to 1,000 employees. Of these companies, 65.4% had annual sales revenues of more than U.S. \$3 million. In addition, 57.7% were Chinese firms

(9.0% were state-owned, 35.8% were private, and 12.9% were stock or public-listed companies) and 42.3% were foreign-owned firms (23.3%) or joint ventures (20.3%). On average, the respondents had been working for 10.9 years in the industry and 6.2 years in their company.

After the fieldwork, one of the authors randomly called 40 respondents to confirm that the interviews had been conducted. No cheating in the fieldwork was found. A comparison between the responding and nonresponding firms using MANOVA indicated there were no significant differences in terms of key firm characteristics (i.e., industry type, firm ownership, the number of employees, and annual sales revenues) (Wilks' $\Lambda = .957$; $F = 1.423$; $p = .658$), suggesting that nonresponse bias is not a concern in our study. To further validate our key informant approach, in 2005 we used Podsakoff and Organ's (1986) post-hoc technique to randomly select 40 firms from those participating in the 2004 survey and conducted on-site interviews with two purchasing managers or directors from each firm. Of the two managers, one had participated in the 2004 survey and the other was a new informant. We successfully obtained responses from 64 managers from 32 firms. The test-retest reliability of the same managers' responses in 2004 and 2005 ranged from .99 (long-standing ties) to .76 (uncertainty) (all $p < .001$), and the inter-rater reliability between the two managers' responses in 2005 ranged from .98 (transaction frequency) to .80 (asset specificity) (all $p < .001$), demonstrating the validity of our key informant approach (cf. Luo, 2002).

Measures

The measures used in the survey were adapted from established studies. The measurement items and validity assessment are presented in the appendix.

Exchange hazards. Transaction cost economics commonly points out two types of hazards to market transactions: asset specificity and environmental uncertainty. *Asset specificity*

refers to transaction-specific assets that are not redeployable for alternative uses (Williamson, 1996). It was measured with five items adapted from Cannon and Perreault (1999). These items capture buyers' specific investments in product features, personnel, inventory and distribution, marketing, and capital equipment and tools to accommodate the suppliers' needs. The measure of *environmental uncertainty* was adapted from Cannon and Perreault (1999) and consisted of five items that assess the environmental changes in the supply market with respect to pricing, product features and specifications, vendor support services, technology, and product supply.

Governance structures. We measured two types of governance structures: relational governance and contract customization. *Contract customization* was measured with three items adapted from Lusch and Brown (1996) that measure the specificity, customization, and details of contractual agreements between manufacturers and their suppliers.

Relational governance is based on the use of shared norms to monitor and coordinate the behaviors of the exchange partners (Macneil, 1980) and is a multidimensional construct consisting of both shared norms and joint actions (e.g., Heide and John, 1992; Jap and Ganesan, 2000; Zaheer and Venkatraman, 1995). Consistent with Jap and Ganesan's work (2000), we measured relational governance as a higher-order factor consisting of information sharing, norm of solidarity, and joint operation. Information sharing has four items that indicate the extent to which two firms share their proprietary information, cost information, product development, and supply and demand forecasts. Norm of solidarity has four items measuring a firm's willingness and commitment regarding shared responsibility. Joint operation contains four items related to the degree to which the buyer and supplier have worked together to facilitate operations.

Long-standing ties. We focus specifically on the length of ties between the buyer and supplier because this is the central element mentioned in the social embeddedness literature that

interfaces with governance choice literature (e.g., Macaulay, 1963, Granovetter, 1985; Gulati, 1995; Uzzi, 1997). We measured the tie (the duration of the relationship) by asking managers how long their firms had been doing business with their suppliers (e.g., Luo and Park, 2001: 148; Poppo and Zenger, 2002: 717; Uzzi, 1999: 493).

Controls. We controlled for three sets of factors. First, two types of transaction characteristics were controlled: frequency and concentration. Transaction cost economics indicates that *transaction frequency* is an important transactional dimension, yet it receives limited attention both theoretically and empirically (Rindfleisch and Heide, 1997: 31). Following John and Weitz (1989), we measured it by asking respondents to indicate how frequently their firms placed purchasing orders with their suppliers. *Exchange concentration* reflects a buyer's dependence on the supplier. Similar to Rokkan, Heide, and Wahne (2003), we measured it as the percentage of the buyer's total annual product needs from the supplier.

Second, due to the prevalent influence of institutional factors in emerging markets (Hoskisson et al., 2000), we controlled for the effects of *foreign ownership* and *business group affiliation*. Prior work has documented that foreign firms tend to have a way of using social ties and contracts that is distinct from that of domestic firms (Li, 2004). Foreign ownership was coded as a dummy variable with 1 = international joint ventures or foreign firms and 0 = otherwise. Following Keister (2001), we coded business group affiliation as a dummy with 1 = buyer and supplier belong to the same business group, and 0 = otherwise.

Third, we controlled for *firm size* and *job tenure* of the respondent because firm size and managers' work experience may be important exogenous factors that affect governance decisions (Poppo and Zenger, 2002). We used the logarithm of number of employees in the company to

indicate firm size, and the length of time the manager had worked for the firm to proxy job tenure.

Common method assessment. Since we collected information on dependent and independent variables from the same respondent, a common method bias might occur. We checked this potential problem with the Harman one-factor test (Podsakoff and Organ, 1986). This technique loads all the variables into an exploratory factor analysis. If (a) a single factor emerges from the factor analysis or (b) factor 1 accounts for the majority of the variances, then common method bias is a concern. In the test, a factor analysis of all the measurement items resulted in a solution that accounted for 68.96% of the total variance, in which factor 1 accounted for 22.92% of the variance. Because a single factor did not emerge, and factor 1 did not explain most of the variance, common method bias is unlikely to be a concern in our data.

Construct validity. We refined the measures and assessed their construct validity following the guidelines suggested by Anderson and Gerbing (1988). First, exploratory factor analyses were run for each of the multiple-item variables, which resulted in factor solutions as expected theoretically. Reliability analyses further showed that these measures possessed satisfactory coefficient reliability. Then, confirmatory factor analyses were run for each of the three sets of constructs (i.e., relational governance, governance structures, and exchange hazards), as well as an overall eleven-factor model with all the variables included (see the appendix). After we dropped one item with high cross-loading, all the confirmatory models fit the data satisfactorily (e.g., the overall model: $\chi^2(182) = 531.26$, $p < .001$; GFI = .90, CFI = .92, IFI = .92; RMSEA = .069), indicating the unidimensionality of the measures (Anderson and Gerbing, 1988). Further, all factor loadings were highly significant ($p < .001$). The composite reliabilities of all constructs ranged from .798 to .938, well above the usual .70 benchmark. The

average variance extracted for every construct was above the .50 cutoff (Fornell and Larcker 1981). Thus, these measures demonstrate adequate convergent validity.

We assessed the discriminant validity of the measures in two ways. First, we ran pairwise, chi-square difference tests for all the multiple-item scales to assess if the restricted model (correlation fixed at 1.0) fit the data significantly worse than the freely estimated model (correlation estimated freely). All the chi-square differences were highly significant (e.g., the test for asset specificity and uncertainty: $\Delta\chi^2(1) = 747.366, p = .000$), providing evidence for discriminant validity (Anderson and Gerbing, 1988). Second, we performed a more-stringent test to determine whether the average variance extracted for each construct is greater than its highest shared variance with other constructs (Fornell and Larcker 1981). The results show that for each construct, the average variance extracted was much higher than its highest shared variance with other constructs, providing additional support for the discriminant validity (see the appendix) (Fornell and Larker, 1981). Overall, these results show that our measures possess satisfactory reliability and validity.

The results of CFA such as goodness-of-fit index, factor loading, and composite reliability are reported in the appendix. Table 1 presents means, standard deviations, and correlations for the constructs.

Insert Table 1 about here.

ANALYSES AND RESULTS

To test the hypotheses, we employed structural equation modeling with maximum likelihood estimation method, using Figure 1 as the baseline model. In the model, asset specificity, environmental uncertainty, and long-standing ties are treated as important exogenous

constructs, with relational governance the intermediate variable and contract customization the dependent variable. We also explore whether the use of long-standing ties is triggered by exchange hazards by specifying a link between hazards and ties. The control variables are also included in the model and are linked directly to the endogenous variables. The model fits the data satisfactorily ($\chi^2 (182) = 531.26, p < .001, GFI = .90, CFI = .92, IFI = .92; RMSEA = .069$). The results are summarized in Table 2.

Insert Table 2 about here.

Consistent with H1, the results show that increasing levels of asset specificity ($b = .141, p < .01$) and environmental uncertainty ($b = .099, p < .05$) lead to greater levels of relational governance. Apparently, managers develop relational governance to safeguard their interests and investments from transactional risks. Consistent with our assumption that managers are unlikely to customize contracts in response to exchange hazards because of weak legal institutions, the results show that asset specificity and environmental uncertainty do not lead to greater contract customization. In fact, asset specificity has a negative effect on contract customization ($b = -.199, p < .001$). Thus, exchange hazards do not directly lead to greater levels of contract customization.

H2 tests the relationship between relational governance and contract. The results show that the greater the level of relational governance, the higher the level of contract customization ($b = .452, p < .001$). This supports our proposed logic (H2) but not the substitution proposition (H2alt). The results of H1 and H2 together suggest that relational governance *accounts for* the effects of hazards on contracts. In other words, exchange hazards point to the choice of

relational governance, not contracts; then relational governance promotes the customization of contracts.

H3 examines whether longer exchange relationships are associated with greater levels of relational governance. Consistent with prior empirical findings that relational governance emerges from prior ties (e.g., Poppo and Zenger, 2002), we find support for H3: longer exchange histories are associated with greater levels of relational governance ($b = .147, p < .01$).

Additional findings. The determinants of the use of long-standing ties are worth noting. More-concentrated exchanges are positively associated with supply relationships of a longer duration ($b = .140, p < .01$), suggesting that a high level of dependence is associated with long-standing exchange ties. Not surprisingly, institutional parameters, such as business group affiliation ($b = .130, p < .05$), larger firms ($b = .114, p < .01$), and managers with longer job tenure ($b = .392, p < .001$), increase firms' reliance on long-standing trading partners. These results illustrate sources of a tradition of retaining long-standing trading partners.

Furthermore, exchange concentration leads to a greater degree of relational governance ($b = .133, p < .05$). Foreign ownership, including both international joint ventures and foreign firms, is more likely to rely on customized contracts ($b = .158, p < .01$). If buyer and supplier belong to the same business group, they are more likely to develop greater levels of relational governance ($b = .336, p < .001$) and less likely to use contracts to coordinate exchanges ($b = -.230, p < .001$). Interestingly, a longer job tenure decreases the development of relational governance ($b = -.138, p < .01$) but increases the use of customized contracts ($b = .142, p < .05$).

DISCUSSION

Our central argument is that when legal institutions are weak, as in China at this time, relational governance may substitute for, or supplement, weak legal institutions by providing

contractual assurance. That is, managers may select relational governance to safeguard exchanges from hazards, namely asset specificity and uncertainty, and, moreover, use relational governance to enforce and thus promote greater contract customization. The results of this empirical study strongly endorse this argument by suggesting that (1) a transaction cost logic appears to explain the choice of relational governance and (2) relational governance accounts for the relationship between exchange hazards and contracts. That is, the matching of exchange hazards with relational governance, not contracts, suggests that managers view relational governance as a mechanism to safeguard their exchanges from transactional risk. Moreover, the complementarity, not substitution, of relational governance and contracts suggests that contracts appear to govern market exchanges, a finding that contraindicates the perspective that China's historical orientation toward interpersonal accommodation precludes the use of formal institutions (Boisot and Child, 1996; Xin and Pearce, 1996; Li, Park, and Li, 2003).

Relational Contracts in China

Institutional economics states that unpredictability will undermine the use of formal institutions (North, 1990). Similarly, institutionalists argue that creating legitimate structures is critical to the evolution of formal institutions (DiMaggio and Powell, 1983). Thus, it is not surprising that we do not observe the conventional use of contracts in China, namely, that contracts become increasingly complex in response to the transactional risks associated with asset specificity and uncertainty. Because systematic legal enforcement is lacking, the costs of writing contracts exceeds the probable value of their safeguarding function.

We offer that an alternative legitimate structure, relational governance, supports the use of contracts when weak legal institutions exist. Relational governance creates a legitimate structure for sanctioning exchange behavior through its norms and behavioral practices:

solidarity norms, information disclosure, and close operational coordination. Because the presence of transactional risks challenges cooperative exchange behavior, relational governance is more likely to appear when these risks are present. Presumably, these relationally based norms and practices help mitigate opportunistic behavior arising from adaptation and asset specialization, thereby facilitating ongoing coordination and promoting cooperation. Thus, relational governance sanctions behavior and functions as an institutional safeguard. Relational governance further provides contractual assurance because the relational norms and behaviors mentioned above help enforce the contract as a framework for adaptation. As such, contracts offer additional governance by formalizing existing or new routines that promote coordination and thus adaptation of market exchanges. That is, they provide trading parties with greater enforcement capabilities. Our empirical results offer broad support for this perspective: increasing levels of uncertainty and asset specificity lead to higher levels of relational governance, which in turn promotes greater contract customization.

Prior empirical works present mixed support for the argument that a transaction cost logic extends to the choice of relational governance, that is, that managers develop relational governance in response to exchange hazards. Our study suggests, consistent with the approach of others (Sheng et al., 2005; Poppo and Zenger, 2002), that better specification of the institutional environment is necessary to understand when exchange hazards are associated with the use of relational governance. For example, when legal institutions are strong, managers choose contracts, not relational governance, in response to exchange hazards (Poppo and Zenger, 2002). Yet, when legal institutions are weak, they choose relational governance, not contracts, when exchanges hazards exist.

The results of this study also inform the current debate on whether Western notions of governance will typify China's emerging markets. Many argue that replicating a Western governance style in China is problematic because of China's historical orientation toward social institutions and its personalized system of interpersonal accommodation and because information is still largely in the private domain (Boisot and Child, 1996; Xin and Pearce 1996; Li, Park, nd Li 2003). For instance, Boisot and Child (1996) posit that China is moving toward a type of network capitalism defined by long-term trust relationships and a communal system of property rights. Accordingly, "Risks are managed in these networks informally on the basis of accepted social practice rather than by reliance on formal laws of contracts" (p. 622). Yet, our results find no evidence that managers dismiss formal contracts as relational governance increases; rather, as relational governance increases, so does contract customization. This result suggests that the use of personal accommodation does not undermine the legitimacy of contracts, which is highly consistent with the observation of the prevalent use of contracts in China (Zhou et al., 2003).

Consistent with the time-dependent social origin of relational governance (Gulati, 1995; Poppo and Zenger, 2002), our study also finds that relational governance evolves from pre-existing social ties. Prior relations enable parties to evaluate the motives, intent, and capabilities of the others, thereby reducing transactional uncertainty. Armed with this information, parties are more likely to commit to the joint action required by relational governance. Not surprisingly, we further find that business group membership is also associated with long-term trading partners, a finding that is consistent with case observation in China, namely, that parties within the same business group prefer transactions with one another (Keister, 2001).

Limitations and Future Research

Our study represents an initial effort to examine a complex phenomenon, and future research is necessary. For example, our model does not examine costs and benefits associated with relational governance and contracts, a study that is necessary to completely test the efficiency logic of relational contracts. Thus, it would be worthwhile to expand our model by taking governance costs and benefits into consideration. Moreover, a variety of enforcement mechanisms are likely to support the use of relational governance: expectations of repeat business, reputation effects, social obligations, and/or fulfillment of basic social needs. Yet, we have little knowledge of which mechanisms are more effective or critical in regulating the effectiveness of this social institution. Further work is needed to examine whether the effectiveness of relational governance depends on the type of enforcement mechanism. In particular, further empirical work should measure the various types of enforcement mechanisms and their relationships with governance choices and performance.

Our study is based on the static assumption that weak legal institutions exist in China. Over time, however, legal institutions in China may become more-legitimate mechanisms to enforce law (e.g., Guthrie, 1998). Thus, it would be useful to measure variation in court enforcement and the effectiveness of relational contracts. Future research may also consider limits to relational governance as a firm's markets grow in size. According to the logic of new institutional economics, one potential problem of using social institutions to sanction behavior is that as the scale and scope of exchanges increase, exchanges are simply harder to maintain and sanction through long-standing ties because repeat business and cultural homogeneity are less likely (North, 1990). As well, information processing and enforcement become necessarily more difficult as deviations are harder to punish and the likelihood that trust will be exploited and abused increases (Peng, 2003). It is possible that the combined use of relational governance and

contracts may be an efficient solution to such problems because of their enforcement properties and capability to facilitate coordinated adaptation. However, that may not be the case as courts become more-legitimate structures. For example, Johnson, McMillan, and Woodruff (2002) find that, in Eastern Europe, transaction costs are lower when courts are effective than when firms rely on expectations of repeat business to enforce the use of contracts. Further research is encouraged to examine the effectiveness of relational governance and contracts in a cross-regional context in which legal systems vary in their enforcement.

As global competition increasingly defines most commerce, understanding how to structure exchange in emerging markets or, alternatively, clarifying the impact of the institutions in emerging economies on the make-or-buy decision are central governance concerns. The underlying political, social, and legal institutions in emerging economies are often complex, idiosyncratic, and dynamic. Moreover, the impact of such institutions on governance decisions is relatively unknown at this time. Our study informs this general topic by showing the interplay of social and formal governance institutions in an economy with a weak legal institution—i.e., relational governance enforces the use of contracts. We hope that future research will further explore and document governance institutions, governance choices, and their performance in emerging economies.

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FIGURE 1
The Conceptual Model

TABLE 1
Basic Descriptive Statistics of the Constructs

Construct	1	2	3	4	5	6	7	8	9	10	11
1. Asset specificity	1.00										
2. Uncertainty	.32**	1.00									
3. Long-Standing ties	.04	-.05	1.00								
4. Relational governance	.23**	.15**	.19**	1.00							
5. Contract customization	-.10*	.02	.03	.25**	1.00						
6. Transaction frequency	-.06	.02	.09	.16**	.00	1.00					
7. Exchange concentration	.07	-.07	.24**	.31**	-.03	.18**	1.00				
8. Foreign ownership	-.06	.01	.00	.16**	.16**	.17**	.13**	1.00			
9. Business group	.17**	.05	.24**	.44**	-.14*	.18**	.48**	.21**	1.00		
10. Firm size	.01	.09	.15**	.03	.01	.13*	.07	.12*	.10*	1.00	
11. Job tenure	.01	-.08	.40**	-.18**	.13*	-.06	.04	-.20**	.03	.01	1.00
Mean	3.19	3.91	4.98	4.80	5.32	5.18	48.78	.42	.39	5.20	6.21
S.D.	1.39	1.09	4.15	1.03	1.32	1.15	28.09	.49	.49	.99	3.96

Notes: n = 399; ** p < .01; * p < .05 (2-tailed).

TABLE 2
Standardized Structural Equation Parameter Estimates (t-value)

	Long-Standing Ties	Relational Governance	Contract Customization
<i>Exogenous Variables</i>			
Asset specificity	.022 (.439)	.141** (2.542)	-.199*** (-3.353)
Environmental uncertainty	-.028 (-.540)	.099* (1.979)	.014 (.232)
Long-Standing ties	—	.147** (2.709)	-.038 (-.666)
Relational governance	—	—	.452*** (6.326)
<i>Controls</i>			
Transaction frequency	.055 (1.209)	.070 (1.431)	-.055 (-1.072)
Exchange concentration	.140** (2.769)	.133* (2.415)	-.063 (-1.074)
Foreign ownership	.009 (.191)	.065 (1.296)	.158** (2.987)
Business group affiliation	.130* (2.518)	.336*** (5.866)	-.230*** (-3.611)
Firm size	.114** (2.563)	-.063 (-1.289)	.030 (.591)
Job tenure	.392*** (8.728)	-.138** (-2.597)	.142* (2.513)
<i>R-square</i>	.246	.320	.206
<i>Goodness-of-fit: χ^2 (182) = 531.26, p < .001, GFI = .90, CFI = .92, IFI = .92; RMSEA = .069</i>			

Notes: *** p < .001; ** p < .01; * p < .05.

Appendix: Measurement Items and Validity Assessment

Governance ($\chi^2(85) = 312.69, P < .001; GFI = .92, CFI = .93, IFI = .93; RMSEA=.082$)

Long-Standing Ties

How long (in years) has your company been doing business with this supplier? _____

Contract Customization: CR = .882, AVE = .714, HSV = .075

- | | |
|--|------|
| 1. We have specific, well-detailed agreements with this supplier. | .868 |
| 2. We have customized agreements that detail the obligations of both parties. | .882 |
| 3. We have detailed contractual agreements specifically designed with this supplier. | .782 |

Relational Governance : second-order indicator, CR = .893, AVE = .736, HSV = .229

($\chi^2(41) = 164.99, P < .001; GFI = .93, CFI = .95, IFI = .95; RMSEA=.087$)

Information Sharing: first-order indicator, CR = .906, AVE = .706 SFL .866

- | | |
|---|------|
| 1. It is expected that parties will provide proprietary information if it can help the other party. | .777 |
| 2. It is expected that we keep each other informed about events or changes that may affect the other party. | .784 |
| 3. We always share supply and demand forecasts. | .893 |
| 4. Exchange of information in this relationship takes place frequently. | .900 |

Norm of Solidarity: first-order indicator, CR = .798, AVE = .580 .903

- | | |
|--|------|
| 1. Problems that arise in the course of this relationship are treated by my firm and this supplier as joint rather than individual responsibilities. | .688 |
| 2. Both parties are committed to improvements that may benefit the relationship as a whole, and not only the individual parties. | .815 |
| 3. Both parties in this relationship do not mind owing each other favors. | * |
| 4. In most aspects of the relationship the parties are jointly responsible for getting things done. | .756 |

Joint Operation: first-order indicator, CR = .846, AVE = .570 .800

- | | |
|---|------|
| 1. This supplier plays an active role in the decisions we make regarding the retailing of our products. | .698 |
| 2. We consult this supplier concerning inventory decisions. | .788 |
| 3. This supplier regularly asks our opinions and suggestions for improving its products and services. | .723 |
| 4. This supplier often asks our suggestions for selling and marketing. | .830 |

Exchange Hazards ($\chi^2(34) = 191.35, p < .001; GFI = .93, CFI = .95, IFI = .95; RMSEA=.07$)

Asset Specificity: CR = .938, AVE = .752, HSV = .151

Your firm may have made investments in time, energy, and/or money specifically to accommodate this supplier and its products. These investment would be lost if your firm switched to another supplier. Please indicate the extent to which your firm has made investments or changes *specifically to accommodate* this supplier (1 = none, 7 = a great deal).

- | | |
|---|------|
| 1. Just for this supplier, we have changed our product's features. | .805 |
| 2. Just for this supplier, we have changed our personnel. | .860 |
| 3. Just for this supplier, we have changed our inventory and distribution. | .891 |
| 4. Just for this supplier, we have changed our marketing strategy. | .906 |
| 5. Just for this supplier, we have changed our capital equipment and tools. | .869 |

Environmental Uncertainty: CR = .872, AVE = .582, HSV = .151

In this supply market, the following factors are changing (1 = very infrequently, 7 = very frequently).

- | | |
|---------------------------------------|------|
| 1. Pricing | .553 |
| 2. Product feature and specifications | .820 |
| 3. Vendor support services | .839 |
| 4. Technology used by suppliers | .868 |
| 5. Product supply | .690 |

Control Variables

Transaction Frequency

- How frequently has your company been placing orders with this supplier? (*reverse-coded*) _____
- | | | | |
|--------------------------|---------------------------|-----------------------|-------|
| 1 = More than once a day | 2 = Once a day | 3 = 1-5 times a week | _____ |
| 4 = 2-3 times a month | 5 = Once a month | 6 = 5-11 times a year | _____ |
| 7 = 2-4 times a year | 8 = Once per year or less | | _____ |

Exchange Concentration: What percentage (0-100%) of your company's total annual needs for this product is obtained from this supplier? _____

Foreign Ownership: 1 = international joint venture or foreign firms; 0 = otherwise _____

Business Group Affiliation: 1 = belong to the same business group; 0 = otherwise _____

Firm Size: logarithm of the number of employees of the firm _____

Job Tenure: How long have you been working in this firm? _____

Overall Model Fit: $\chi^2(182) = 531.26, p < .001$; GFI = .90, CFI = .92, IFI = .92; RMSEA = .069

Notes: SFL = standardized factor loading; CR = composite reliability;

AVE = average variance extracted; HSV = highest shared variance with other constructs.

*Item deleted from further analysis due to high cross-loading.