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Interorganizational Governance in Marketing Channels

Relationship management rapidly is becoming a central research paradigm in the marketing channels literature. A growing body of conceptual and empirical literature addresses different aspects of interfirm relationships, building in part on recent theoretical developments in organization theory, law, and economics. Interestingly, however, some of these theoretical frameworks make radically different assumptions about the nature of interfirm relationships, though these differences to date have not been examined systematically in the marketing literature. The author reviews these theoretical perspectives and develops a formal typology of approaches to relationship management. Specifically, he develops a typology of three different forms of governance, which vary systematically in terms of how specific interfirm processes are carried out. He also discusses the antecedents of different relationship forms and shows the results of a preliminary empirical test.

There has been a resurgence of research and theorizing about interfirm relationships in the marketing literature. The trends described more than ten years ago by Arndt (1979) as “market domestication” are becoming increasingly evident, in the form of the emergence of vertical marketing systems (Carman 1980), closer buyer-supplier relationships (Dwyer, Schurr, and Oh 1987) and increasing growth in “partnerships” and other forms of interfirm alliances (Anderson and Narus 1990).

Theoretically, these trends imply that the traditional spot market, to an increasing extent, is being supplanted with alternative mechanisms for governing exchange (Lindblom 1977). From a managerial perspective, they imply that the design of interfirm relationships is becoming a strategic decision variable in its own right. As argued in the extant literature, the nature of a firm’s external relationships could have a profound impact on the implementation of marketing programs (Ruekert, Walker, and Roering 1985), contribute to product differentiation (Porter 1985), and even serve as a barrier to entry into a particular market (Reve 1986).

As the shifts toward nonmarket forms of governance have become more apparent, the limitations of the established research paradigms in marketing have become equally evident (Stern and Reve 1980). As a consequence, researchers have for some time focused their attention on theoretical developments in other areas in attempting to explain these shifts. These areas have included organization theory (Pfeffer and Salancik 1978), institutional economics (Williamson 1985), and contract law (Macneil 1980)—each

of which offers considerable insight into alternatives to market governance. At the same time, these bodies of literature also provide somewhat different perspectives on both the forms that interfirm governance could take and their antecedent conditions. For example, transaction cost theory traditionally has described departures from market-based exchange in terms of shifts toward hierarchical governance (Williamson 1985), whereas contracting theory views this shift as the establishment of relational governance (Macneil 1980). Though both relational and hierarchical governance are viewed appropriately as alternatives to market governance, they represent quite different strategies for managing interfirm relationships. To date, however, the differences among nonmarket governance forms and their implications for relationship management have not been systematically explored in the marketing literature.

My main purpose in this article is to draw on a number of theoretical perspectives on interfirm governance to develop a formal typology of approaches to relationship management. Essentially, I propose that nonmarket governance is a heterogeneous phenomenon and different relationship management strategies are appropriate under different conditions.

In the following section, I present a set of theoretical frameworks that provide different perspectives on interfirm governance. Following this review, I develop a typology of relationship governance forms. I then show the results of a preliminary empirical test involving one particular governance dimension. The final section contains a discussion of implications for marketing theory and practice.

Theoretical Approaches to Interorganizational Governance

The term *governance* traditionally has been defined very broadly as a “mode of organizing transactions” (Williamson and Ouchi 1981). A more precise delineation of the con-

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cept is offered by Palay (1984, p. 265), who defines it as "a shorthand expression for the institutional framework in which contracts¹ are initiated, negotiated, monitored, adapted, and terminated." Stated differently, governance is a multidimensional phenomenon, encompassing the initiation, termination and ongoing relationship maintenance between a set of parties.² As shown subsequently, different theoretical frameworks make somewhat different assumptions about the nature of these processes. Initially, I review the traditional research paradigms from the marketing channels literature. Subsequently, I discuss the perspectives on interfirm governance that follow from resource dependence, transaction cost, and relational contracting theory.³

Marketing Channels Literature

According to Stern and Reve (1980), the traditional marketing channels literature consists of two main research streams, namely, the microeconomic and the behavioral paradigms.

The original microeconomic paradigm, most commonly associated with the work of Bucklin (1970) and Baligh and Richartz (1967), draws on elements of functional and institutional marketing theory as well as neoclassical economics (e.g., Stigler 1951) in explaining the manner in which individual marketing functions are allocated across types of institutions. The general decision criterion underlying these models is economic efficiency, and particular functions are considered candidates for contracting out or "functional spin-off" (Mallen 1973) to the extent that the cost structure for the function in question exhibits increasing returns to scale.

The implicit view of the governance decision in these microeconomic models is a choice between internal and external organization. As such, they parallel the approach subsequently used in transaction cost theory (e.g., Williamson 1975), though the two approaches differ with respect to the types of costs used as explanatory mechanisms.

Several of the microeconomic models subsequently have been criticized, in particular for failing to account for the processes that characterize relationships between channel members. Consistent with neoclassical economic theory, individual firms are viewed in this paradigm simply as "black boxes" or bundles of functions (Nelson 1991), and the relationships between them generally are not conceptualized beyond the functional interdependencies that exist.

In part as a response to the identified limitations of the microeconomic models, a behavioral research paradigm evolved, the primary focus of which was on the design of mechanisms for controlling the role performance of individual channel members (Stern 1969). In a general sense, gov-

ernance in this paradigm is a matter of establishing and employing power, subject to the overarching goal of coordinating the efforts of different channel members. (For extensive reviews of this literature, see Frazier 1983; Gaski 1984; Hunt, Ray, and Wood 1985; and Reve and Stern 1979.)

In spite of the important insights provided, the behavioral research paradigm also has been subject to criticism, most commonly for focusing on behavioral phenomena in isolation from their antecedent conditions and outcomes (Gattorna 1978, Robicheaux and El-Ansary 1975/76). For instance, with few exceptions (Gaski and Nevin 1985), virtually no attempt has been made to specify the relationship between power and performance, though the notion of system performance represents a key theoretical building block of this paradigm. Furthermore, the behavioral literature, with few exceptions (Mohr and Nevin 1990), has given only limited attention to the effect of contextual variables, such as the conditions under which particular power strategies are appropriate.

A joint consideration of the two research streams discussed previously leads to a view of channel decisions as a general trade-off between costs and control (Anderson and Weitz 1983; Cespedes 1988; Lambert 1966). On the one hand, internalizing a particular channel function is assumed *a priori* to offer superior control opportunities by virtue of the employment relation created. On the other hand, however, the control advantage associated with ownership is likely to be a trade-off with the cost efficiency of contracting out to external specialists, who are in a position to achieve economies of scale by virtue of "pooling" multiple demand curves.

Unfortunately, the cost versus control decision rule has some inherent limitations. First, scale economies only account for one component of the relevant costs. Second, control is not an inherent property of integrated channel systems. Even in cases in which a particular function is internalized, specific control mechanisms must be put in place, and choices exist between control mechanics with fundamentally different properties (Anderson and Oliver 1987). Moreover, the mechanisms that can be used for governing an integrated system also can be built explicitly into the relationship between vertically adjacent channel institutions. In fact, some authors (e.g., Coughlan 1985; Jeuland and Shugan 1983) have suggested that interfirm agreements can be structured in such a way as to make integrated and non-integrated channels "indistinguishable" (McGuire and Staelin 1983, p. 189). As such, the key issue is not necessarily ownership or integration per se, but rather the manner in which a particular relationship is organized.

Resource Dependence Theory

Building on early work in social exchange theory (e.g., Emerson 1962; Thibaut and Kelley 1959), resource dependence theory views interfirm governance as a strategic response to conditions of uncertainty and dependence (Pfeffer and Salancik 1978). Given the underlying assumption that few organizations are internally self-sufficient with respect to their critical resources, two potential problems are created. First, a lack of self-sufficiency creates potential depend-

¹The term *contract* is used by Palay in a very broad sense, and does not necessarily describe a formalized, legally binding document. Similar definitions of governance have been used by Moe (1984) and Williamson (1985).

²Note that governance as defined here is a much broader concept than control. Essentially, governance includes elements of establishing and structuring exchange relationships as well as aspects of monitoring and enforcement.

³A somewhat parallel framework, agency theory, will not be reviewed explicitly in this article. For an excellent discussion, see Bergen, Dutta, and Walker (1992).

ence on the parties from whom the focal resources are obtained (Emerson 1962). Second, it introduces uncertainty into a firm's decision making, to the extent that the resource flows are not subject to the firm's control, and may not be predicted accurately.

The main premise of resource dependence theory is that firms will seek to reduce uncertainty and manage dependence by purposely structuring their exchange relationships by means of establishing formal or semiformal links with other firms (Pennings 1981; Ulrich and Barney 1984). A variety of such links has been suggested in the extant literature, including contracting (Miles, Snow, and Pfeffer 1974), joint ventures (Pfeffer and Nowak 1976), and complete merger (Pfeffer 1972). Conceptually, the establishment of an interfirm link is viewed in this literature as dealing with the problems of uncertainty and dependence by deliberately increasing the extent of coordination with the relevant set of exchange partners or creating "negotiated environments" (Cyert and March 1963).

For present purposes, the main implication of resource dependence theory is its identification of dependence and uncertainty as the key antecedent variables motivating the establishment of interfirm relationships. However, this theory offers only limited insight into the specific mechanisms that can be used to govern relationships, beyond "global" strategic alternatives like contracting and joint ventures. Though the strategies discussed in the literature all could serve to deal with uncertainty and dependence in a general sense, they vary greatly in terms of the requirements they impose on a firm and the benefits they offer (Scott 1987).

Transaction Cost Theory

In a general sense, transaction cost theory views governance in terms of designing particular mechanisms for supporting economic transactions. The original framework, as developed by Williamson (1975), views the governance decision as fundamentally a choice between a "market," based on governance through a price mechanism, and a "hierarchy," implying governance through a unified authority structure.

Contrary to resource dependence theory, the transaction cost framework explicitly considers the efficiency implications of adopting alternative governance mechanisms. As described by Williamson (1975), certain dimensions of transactions give rise to transaction costs⁴ and combine to create "market failure" in the sense that the market mechanism becomes an inefficient means of mediating exchange. These dimensions are *transaction-specific investments* and *external and internal uncertainty*.

Transaction-specific investments involve physical or human assets that are dedicated to a particular relationship and cannot be redeployed easily. Their idiosyncratic nature

⁴Transaction costs have been defined by Arrow (1969) as the "costs of running the system." These can include search and information costs, as well as costs of monitoring and enforcing contractual performance. Resulting from the presence of various market imperfections, traditional microeconomic models of exchange (e.g., Bucklin 1966) do not account for these costs. Organization theorists have discussed certain types of transaction costs in terms of "coordination costs" (Thompson 1967), though the full scope of these costs is not reflected in any prior theoretical framework.

gives rise to a *safeguarding* problem, in the sense that mechanisms must be designed to minimize the risk of subsequent opportunistic exploitation (Klein, Crawford, and Alchian 1978; Williamson 1985). The second dimension, external uncertainty, is a property of the decision environment within which exchange takes place. To the extent that the relevant contingencies are too numerous or unpredictable to be specified *ex ante* in a contract, an *adaptation* problem exists (Rubin 1990). Essentially, mechanisms must be put in place to permit adjustments to be made as events unfold.⁵ Finally, internal uncertainty or performance ambiguity poses an *evaluation* problem in connection with ascertaining whether contractual compliance has taken place (Alchian and Demsetz 1972).

The main premise of transaction cost theory is that there are potential costs associated with carrying out safeguarding, adaptation, and evaluation processes.⁶ The general response to these governance problems identified in the original transaction cost framework is complete vertical integration. Theoretically, the authority relations and hierarchical control procedures available through internal organization are assumed *a priori* to have inherent safeguarding, adaptation, and evaluation capabilities. Recent theoretical extensions, however, have shown that the governance features of internal organization also can be achieved within the context of interfirm relationships. As argued by Stinchcombe (1985), unilateral provisions can be built into contracts that are essentially the functional equivalents of an organizational hierarchy. In addition, bilateral trading relationships can be crafted that minimize potential governance problems in the first place (Williamson 1985, 1991a).

Transaction cost theory parallels resource dependence theory in that it views nonmarket governance as a response to environmental uncertainty and dependence. Regarding the latter, transaction-specific assets can be argued to constitute dependence, because their presence makes exchange partners irreplaceable or replaceable only at a cost (Barney and Ouchi 1986). The two theories differ, however, in that transaction cost theory explicitly accounts for the efficiency implications of organizing relationships, whereas resource dependence essentially limits its treatment of performance to effectiveness considerations, or the ability to satisfy the demands of external parties per se (Pfeffer and Salancik 1978).

⁵It should be pointed out that the original transaction cost framework proposes that the interaction between external uncertainty and specific assets, rather than the individual variables, is the key determinant of a firm's governance decision. Recent research, however, has suggested that there are distinct governance processes involved in organizing transactions, which have distinct costs associated with them (Malone 1987). For example, adapting to uncertainty could be costly in itself, in that "processing information takes time and effort even when parties share organizational goals" (Holmstrom and Tirole 1989, p. 64). In addition, a large number of empirical studies have shown main effects of uncertainty and specific assets on a number of different governance dimensions.

⁶The transaction costs associated with these governance processes are basically of two different kinds. First, there are direct costs associated with carrying out safeguarding, adaptation, and evaluation activities. Second, there are opportunity costs involved, for example, in the form of maladaptation (Malone 1987, Masten, Meehan, and Snyder 1991) or incurred as a result of appropriate investments not being undertaken. Admittedly, the broad scope of these costs stretches traditional concepts of costs and efficiency.

Relational Contracting Theory

Building in part on Macaulay's (1963) seminal study on non-contractual business relations, Macneil (1978, 1980) developed a formal typology of "discrete" versus "relational" exchange. Discrete exchange is consistent with the underlying assumptions of neoclassical economic theory, in which individual transactions are assumed to be independent of past and future relations between the contracting parties and constitute nothing more than the transfer of ownership to a product or service (Goldberg 1976). Under discrete exchange the individual parties to a transaction remain autonomous, pursue their interests vigorously, and rely to a large extent on economic and legal sanctions for the purpose of enforcing contractual obligations. Relational exchange, in contrast, accounts explicitly for the historical and social context in which transactions take place and views enforcement of obligations as following from the mutuality of interest that exists between a set of parties (Dwyer, Schurr, and Oh 1987; Kaufmann and Stern 1988).

The notion of relational exchange is somewhat analogous to Ouchi's (1979) concept of a clan mechanism. Clan governance is essentially a normative process in which the members of a system come to adopt the norms of the larger system through socialization efforts. As a consequence, deviance or opportunism is dealt with in a proactive fashion; members use self-control based on their internalized values. Similarly, relational exchange appears to capture the spirit of a bilateral power system (Bonoma 1976), in which individuals' utility functions are subsumed by the global utility of the system, and individual decision makers as a consequence adopt a "unit action" orientation. Individual goals are reached in a bilateral system through joint accomplishments, and concern for the long-run benefit of the system serves as a restraint on individual tendencies to pursue their self-interest in an opportunistic fashion. Though some of the extant models of bilateral governance were developed in intrafirm settings (Ouchi 1979), subsequent work has applied explicitly the basic concept to relations between firms (Barney and Ouchi 1986).

The theories of bilateral governance are important because they identify a form of governance that differs in many respects from the ones implied in other theoretical frameworks. Specifically, transaction cost theory historically has been criticized for failing to account for the social structures within which exchange is "embedded" (Granovetter 1985) and overemphasizing the ability of hierarchical mechanisms to govern relationships (Maitland, Bryson, and Van de Ven 1985). It is noteworthy, however, that the recent extensions of the original transaction cost framework (Williamson 1985, 1991a) explicitly incorporate a number of Macneil's notions and also acknowledge the possible existence of bilateral relations. Unfortunately, both transaction cost theory and the emerging sociological perspectives are less than explicit regarding the particular properties of bilateral governance and offer only limited insight into its antecedent conditions.

Therefore, on the basis of the existing literature, it is not clear which specific conditions favor bilateral governance over other governance forms. Besides Ouchi's (1979) origi-

nal hypothesis that bilateral structures are superior in their ability to deal with performance ambiguity, the literature offers little guidance as to the conditions under which they are appropriate. Macneil's own work is of limited help in this respect, because he fails to make explicit predictions, making only the general assumption that bilateral elements are required for a set of parties to "project their exchange into the future" (Macneil 1980). Implicitly, however, the theory of relational contracting is based on a recognized need for adapting relationships to changing circumstances, and as such parallels some of the adaptation arguments proposed in transaction cost theory. In fact, as expanded on subsequently, recent empirical research has shown bilateral governance to be highly efficient for the purpose of dealing with certain forms of uncertainty (Noordewier, John, and Nevin 1990).

A Governance Typology

On the basis of the theoretical frameworks presented in the previous section, a distinction can be made at a very general level between market and nonmarket forms of governance. For present purposes, market governance will be viewed as synonymous with the concept of discrete exchange (Goldberg 1976; Macneil 1978), whose distinguishing features are well illustrated in Dwyer, Schurr, and Oh's (1987, p. 12) example of "a one-time purchase of unbranded gasoline out-of-town at an independent station paid for with cash." Though such extreme manifestations of discrete exchange may not be found frequently in practice, the notion of discreteness provides a useful analytical baseline from which other governance forms can be studied.

Generally, when discrete exchange is abandoned, some form of a relationship is crafted. In Macneil's (1978, p. 858) terms, the antithesis of discreteness is the "integration into a relation." Stated differently, some deliberate or formalized governance apparatus has been designed to replace the "invisible hand" of the market.

I argue, however, on the basis of the different bodies of literature reviewed, that nonmarket governance is a heterogeneous syndrome. Using Macneil's terminology, it is conceivable that "integration into a relation" is not a generic phenomenon, but can be subject to systematic variation. For example, Macneil's (1981) own theory of relational exchange explicitly describes the departure from discrete exchange in terms of the establishment of a bilateral relation, in which the parties jointly develop policies directed toward the achievement of certain goals. Examples of such relationships are some of the logistic alliances recently examined by Bowersox (1990) and the "Just-in-Time" relationships Frazier, Spekman, and O'Neal (1988) describe.

In contrast, a relation also can be organized in a unilateral fashion, by means of an authority structure that provides one exchange partner with the ability to develop rules, give instructions, and in effect impose decisions on the other (Hart 1990; Simon 1991). Importantly, the ability to govern by means of authority is not limited to intrafirm settings, but also can be achieved between firms by means of contractual provisions, which essentially "produce the ef-

TABLE 1
Dimensions and Forms of Interfirm Governance

Dimension	Governance Form	Market Governance		Nonmarket Governance	
				Unilateral/Hierarchical	Bilateral
1. Relationship Initiation	No particular initiation process			Selective entry; skill training	Selective entry; value training
2. Relationship Maintenance					
2.1 Role Specification	Individual roles applied to individual transactions			Individual roles applied to entire relationship	Overlapping roles; joint activities and team responsibilities
2.2 Nature of Planning	Nonexistent; or limited to individual transactions			Proactive/unilateral; binding contingency plans	Proactive/joint; plans subject to change
2.3 Nature of Adjustments	Nonexistent; or giving rise to exit or immediate compensation			<i>Ex ante</i> /explicit mechanism for change	Bilateral/predominantly negotiated changes through mutual adjustment
2.4 Monitoring Procedures	External/reactive; measurement of output			External/reactive; measurement of output and behavior	Internal/proactive; based on self-control
2.5 Incentive System	Short-term; tied to output			Short- and long-term; tied to output and behavior	Long-term; tied to display of system-relevant attitudes
2.6 Means of Enforcement	External to the relationship; legal system/competition/offsetting investments			Internal to the relationship; legitimate authority	Internal to the relationship; mutuality of interest
3. Relationship Termination	Completion of discrete transaction			Fixed relationship length, or explicit mechanisms for termination	Open-ended relationship

facts of hierarchies'' (Stinchcombe 1985, p. 165). As an example, franchising contracts frequently contain unilateral specifications of standard operating procedures, incentive systems, monitoring mechanisms, and termination clauses (Rubin 1978, 1990). It is interesting to note in this regard that Macneil's own analysis, though it focuses primarily on bilateral forms of governance, also explicitly recognizes the existence of unilateral governance forms that are based on hierarchical command (Macneil 1981).

At a very general level, then, it appears reasonable to make a distinction between market and nonmarket governance on the basis of the criterion that a "relation" is created, and to further distinguish between unilateral and bilateral forms of nonmarket governance on the basis of the manner in which the relation is established and maintained. Though somewhat different terminology is being used, similar governance trichotomies can be found in other branches of the social sciences, such as law (Black 1984), sociology (Bradach and Eccles 1989; Butler 1983), social psychology (Bonoma 1976), and organization theory (Pennings and Woiceshyn 1987).⁷

This trichotomy, though it delineates in a conceptual sense the forms that interfirm governance can take, is still

⁷As elaborated subsequently, this typology essentially is based on three distinct "ideal types" (in a Weberian sense) of governance forms, as opposed to three points on a single continuum. For example, relational contracting theory essentially represents a distinct form of governance (i.e., bilateral), which does not necessarily represent a midpoint between market and hierarchy. Our approach here is consistent with recent sociological analyses of governance issues (e.g., Bradach and Eccles 1989), which have strongly criticized previous attempts to organize governance forms along a single dimension.

of somewhat limited value for present purposes. Essentially, the three governance forms are "second-order" constructs, which do not have direct real-world equivalents, but manifest themselves in terms of specific governance processes (Cheung 1983; Grandori 1987). Unfortunately, the nature of these processes and their variation across governance forms are not well established in the extant literature. Most commonly, the differences among market, unilateral, and bilateral governance are explained at a very general level in terms of a predominant reliance on a price mechanism, bureaucratic structures, and socialization processes, respectively (Bradach and Eccles 1989; Maitland, Bryson, and Van de Ven 1985). Alternatively, their differences are examined with respect to a single governance process like monitoring (Ouchi 1979). As shown subsequently, the differences among governance forms are much more fundamental in nature and they imply radically different approaches to relationship management. Subsequently, I identify a set of generic governance processes, which differ systematically in nature across the three governance forms.

As a starting point, recall that interfirm governance was defined previously in a broad sense in terms of certain initiation, termination, and relationship maintenance processes. As shown in Table 1, these processes exhibit systematic variation across market, unilateral, and bilateral governance forms. Consider each in turn.

Relationship Initiation

Conceptually, relationship initiation involves an evaluation of potential exchange partners, initial negotiations about aspects of the subsequent relationship, and preliminary adap-

tation efforts (Dwyer, Schurr, and Oh 1987). As shown subsequently, systematic differences exist among governance forms in terms of the general focus of the initiation processes.

In its pure form market governance does not require an initiation process, because exchange partners' identities are assumed to be immaterial (Butler 1983). However, both hierarchical and bilateral governance are based on selective entry processes, though the processes involved are quite different in nature. Bilateral governance involves the more stringent initiation process, in that the initial evaluation could involve assessments of not only skills or qualifications but also certain attitudes or values. For example, manufacturers' initial evaluations of channel members frequently go beyond the assessment of objective skill criteria, such as product knowledge and financial strength, to include evaluations of a distributor's attitude toward the product and the manufacturer's programs (Stern and El-Ansary 1992). In addition, programs frequently are designed specifically to test and cultivate relationship-specific attitudes, above and beyond the development of particular product knowledge (Zellner 1989). Essentially, the initiation procedures in a bilateral governance mode seek to eliminate goal divergence and align incentives *ex ante*, through a form of cultural initiation or socialization process. As such, bilateral governance could be superior in its ability to economize on ongoing governance costs, but could involve significant setup efforts (Grandori 1987).

Interestingly, though the manner in which relationship initiation is carried out differs systematically across governance forms and could have profound implications for how relationships are managed subsequently (Frazier 1983), this particular governance aspect has been subject to only limited empirical inquiry. However, there is evidence from one recent study that the presence of performance ambiguity and transaction-specific assets tend to increase the extensiveness of firms' supplier verification efforts (Heide and John 1990). Consistent with bilateral governance theory, transactional difficulties were handled in these relationships by making entry increasingly selective.

Relationship Maintenance

The ongoing maintenance of interfirm relationships requires that certain subprocesses be carried out. First, an initial system for assigning decision rights among the parties to a relationship must be crafted (Jensen 1983). In operational terms, *roles* must be specified and allocated to the different exchange partners (Frazier 1983; Gill and Stern 1969; Macneil 1978). Furthermore, relationship maintenance requires the development of a *planning* mechanism, or system by which future contingencies and consequential rights and responsibilities are spelled out (Barney and Ouchi 1986; Macaulay 1963). In addition to planning itself, *adjustment* mechanisms must be designed to adapt the ongoing relationship to changing circumstances (Macneil 1978; Wachter and Williamson 1978). A fourth key aspect of relationship maintenance is some form of a *monitoring* system by which to ascertain the degree to which contractual performance has taken place (Rubin 1990, Ouchi 1979). Closely

associated with the monitoring system is an *incentive* system, which allocates rewards to the parties on the basis of observed performance levels (Holmstrom and Tirole 1989, Stinchcombe 1985). Finally, ongoing governance could require the presence of explicit *enforcement* mechanisms above and beyond the incentive system itself, to ensure that contractual obligations are upheld (Macaulay 1963; Palay 1984). Consider next the specific manner in which these processes are carried out in the three governance forms.

Role specification. Role specification describes the manner in which decisions and functions are assigned to the parties in a relationship (Gill and Stern 1969). Under market governance, roles apply to discrete transactions and are basically unidimensional or defined narrowly in terms of some minimum level of duties required by the relevant parties to complete the exchange (Kaufmann and Stern 1988). In contrast, a departure from market governance requires that roles be specified for an extended relationship or series of transactions. Under unilateral governance, the process by which roles are specified is by definition unilateral in nature, in the sense that roles are imposed by one party on the other by means of authority. For instance, distribution and franchising contracts frequently contain explicit *a priori* specifications of the franchisee's or distributor's duty with respect to customer service, inventory maintenance, and the like (Rubin 1978).

Role specification under bilateral governance deviates even further from market governance, in that roles become not only more complex or multidimensional in nature (Kaufmann and Stern 1988) but also more integrated with those of the exchange partner. For instance, a number of manufacturers have initiated joint marketing programs with distributors (Anderson and Narus 1990) and established logistics alliances based on an explicit synchronization of interfirm activities (Bowersox 1990). Using Laumann, Galaskiewicz, and Marsden's (1978) terminology, interfirm roles under bilateral governance can become so closely intertwined that the firms in question are approaching a complete "interpenetration" of their respective boundaries.

Though empirical evidence with respect to this governance dimension is limited, two studies by Palay (1984) and Heide and John (1990) show overlapping roles to be partly a function of the extent to which transaction-specific assets have been deployed. In other words, both studies show evidence of a bilateral governance process.

Planning. Interfirm planning refers to the processes by which future contingencies and consequential duties and responsibilities in a relationship have been made explicit *ex ante* (Macaulay 1963). Again, as an extreme condition, market governance by virtue of its emphasis on discrete transactions implicitly assumes planning over time to be nonexistent. At best, planning is limited to individual transactions or reactive problem solving on the completion of a transaction (Frazier, Spekman, and O'Neal 1989). A key feature of hierarchical governance, in contrast, is the use of formalized contingency plans, specifying *ex ante* categories of environmental events and corresponding procedures and contractual obligations (Cyert and March 1963). In addition, the planning process in a hierarchical system is centralized,

in that the authority to make decisions and specify actions is concentrated within one of the parties. Certain types of franchising contracts capture the spirit of this form of planning (Rubin 1978).

Planning in a bilateral governance mode is similar to hierarchical planning in that it is basically proactive in nature. At the same time, bilateral planning exhibits significantly lower levels of specificity and completeness than its hierarchical counterpart. Plans are viewed under bilateral governance as aids or frames of reference rather than strict specifications of duties. As such, plans represent frameworks within which subsequent adaptations can, and are expected to, take place (Macneil 1980). Furthermore, planning in a bilateral governance mode is by its very nature a decentralized activity, in that the parties exchange information and participate in the process in a joint fashion (Bonoma 1976; Frazier, Spekman, and O'Neal 1988; Noordewier, John, and Nevin 1990). As an example, some manufacturers systematically involve distributors in their marketing planning activities and essentially have made it a cooperative effort (Hardy and Magrath 1988).

Several different empirical studies have investigated the antecedents of different aspects of interfirm planning processes. In one study, Dwyer and Welsh (1985) find bilateral decision-making processes to follow from environmental heterogeneity. In a second study, Dwyer and Oh (1987) show bilateral patterns to be a function of power-dependence considerations, or more specifically of the degree of munificence in a dealer's market. Noordewier, John, and Nevin (1990) demonstrate that the design of bilateral decision-making processes under conditions of uncertainty actually enhance certain aspects of performance in industrial purchasing relationships. In the previously mentioned study, Palay's (1984) results show the presence of transaction-specific assets to be associated with bilateral planning processes.

Adjustment processes. Given the short-term nature of interactions under market governance, the need for making ongoing adjustments is somewhat limited by default. To the extent that changes are contemplated by either party, they tend to give rise to transaction cancellation ("exit") or some form of immediate compensation. Hierarchical governance provides explicitly for the ability to make changes, by means of designing specific devices *ex ante* by which adjustments are to be made, such as contractual escalator clauses (Wachter and Williamson 1978). In effect, hierarchical governance deals with future adjustments by designing *a priori* the mechanisms by which changes will be carried out.

In contrast, adjustments under bilateral governance are based on processes of mutual adjustment (Thompson 1967), in which the parties are prepared to show flexibility and will negotiate adjustments as environmental events unfold (Noordewier, John, and Nevin 1990). Changes in agreements will be expected, but may not be carried out by means of a formally designed mechanism. Furthermore, the change process itself is bilateral in nature in that the parties in question jointly negotiate and implement changes (Dwyer, Schurr, and Oh 1987).

Monitoring procedures. Conceptually, performance monitoring involves establishing the extent to which contractual compliance has taken place. In principle, this can be accomplished externally by explicitly measuring outputs or behavior, or internally, by aligning the incentives of decision makers *ex ante* to reduce the need for performance measurement altogether (Eisenhardt 1985). Both market and hierarchical governance are based on the use of external measurement procedures, though they emphasize measuring output and behavior, respectively (Anderson and Oliver 1987). The measurement process in either case is reactive, in that it takes place upon task completion. In contrast, bilateral governance deals with the measurement problem in a proactive fashion, through socialization processes that promote (internal) self-control. As a consequence, the need for reactive measurement efforts is reduced greatly (Ouchi 1979).

In practice, measurement problems could exist that require different monitoring mechanisms to be employed simultaneously. For instance, even if outputs can be measured, monitoring problems could prevail unless a relevant standard can be established. If a meaningful standard for some reason is unavailable, output measurement may need to be supplemented with behavior controls and/or socialization processes.

Incentive system. The types of incentives used and the basis on which they are distributed have been argued to constitute a key aspect of governance (Holmstrom and Tirole 1989). In their pure forms, both market and hierarchical governance are based explicitly on tying incentives to some aspect of performance, though the specific performance measure used as an allocation device may differ. Incentives under market governance are inherently short term in nature and are tied directly to the completion of a transaction, in the form of resale profits or commission payments tied to output measures (John and Weitz 1989). In contrast, a hierarchical reward system is more long term in nature, and supplements outcome-based incentives with rewards based on observed behavior (Anderson and Oliver 1987). In its pure form, this implies salary compensation.

Incentives under bilateral governance are to a lesser extent made contingent on specific aspects of performance and depend on the display of system-relevant attitudes as well as on overt behavior (Ouchi 1979). In their pure form, bilateral governance structures distribute rewards on the basis of displayed commitment to the system, and overt compliance. In practice, this implies that incentive systems become inherently long term in nature, and parties could forego present rewards on the basis of expectations of long-run equity. In addition, in a purely bilateral system, the identification with the system represents a reward in its own right (Simon 1991).

It should be noted that though this discussion highlights the principal differences among governance forms, it represents an oversimplification of the manner in which incentives can be allocated. For instance, several different mechanisms exist for generating resale profits, many of which have unique properties and can be used to promote different reseller behaviors. Examples are quantity discounts (Jeuland and Shugan 1982), two-part tariffs (Moorthy

1987), and royalty payments (Rubin 1990). In addition, different functional incentives, such as cooperative advertising and promotional allowances (Bergen and John 1991), can be used to provide rewards. (For a more comprehensive discussion of incentive structuring, see Bergen, Dutta, and Walker 1992.)

Empirically, John and Weitz's (1989) study of compensation mechanisms found firms' use of salary-based compensation to be associated with the difficulty of using output measures. Furthermore, salary compensation was shown to be determined in part by the difficulty of replacing salespeople, a condition caused by the presence of company-specific assets. These results are consistent with other studies of compensation structure (Eisenhardt 1985).

Means of enforcement. Finally, ongoing relationship maintenance could require that explicit enforcement mechanisms be designed, above and beyond the incentive system that exists. Again, the manner in which enforcement takes place differs radically across governance forms. One of the defining characteristics of market governance is that the relevant enforcement mechanisms are external to a given relationship, through the use of the legal system (Palay 1984), maintenance of competition (Walker and Weber 1984), or offsetting investments in other relationships (Heide and John 1988).

Both hierarchical and bilateral governance forms rely more heavily on internal enforcement mechanisms, though they differ in nature. Hierarchical governance is based explicitly on enforcement by means of legitimate authority, either through an employment relation or a contractual arrangement that provides decision-making authority in certain areas (Stinchcombe 1985). In contrast, enforcement of obligations under bilateral governance follows from certain aspects of the ongoing relationship itself. Two specific processes could exist. First, to the extent that common values have been established, the need for explicit enforcement could be low in general. Second, expectations of future interaction could represent an incentive to abide by the norms of the relationship and serve as an enforcement mechanism in its own right (Axelrod 1984). To the extent that a set of parties values their ongoing relation, an incentive actually could exist for showing flexibility in enforcing contractual terms. In fact, "forbearance" (Williamson 1991a) is not only a property of internal organization, but is frequently the norm in many interfirm relationships (Macaulay 1963).

Choices among enforcement mechanisms has to date been subject to only limited empirical inquiry. Palay (1984) found the presence of specific assets to be associated with enforcement of obligations based on mutuality of interest, as opposed to threat of termination or maintenance of competition. In a study of manufacturer's agents, Heide and John (1988) found evidence that agents who had made principal-specific investments tended to bond themselves closely with their end customers to safeguard their investments and enforce relationship obligations. In this particular context, enforcement by legal or hierarchical means was unavailable to the agents, and instead an enforcement mechanism was developed that created an explicit disincentive for principal opportunism. In fact, this study showed that such enforcement

strategies on the part of the agents actually enhanced their performance under conditions of high specific assets.

Interestingly, the processes by which enforcement takes place in these examples are quite different in nature. Hierarchical governance is based inherently on enforcement by means of direct controls, whereas enforcement under both market and bilateral governance relies on the presence of a particular incentive structure. For instance, both strategies to maintain competition and efforts to establish mutuality of interest are designed to achieve compliance by means of making certain behaviors desirable or undesirable, as opposed to specifying and monitoring the relevant behaviors directly, as would be the case under hierarchical governance.

Relationship Termination

Systematic variation with respect to relationship termination also exists between the three governance forms. At one extreme, market governance views interfirm relationships as nothing more than a series of discrete exchange episodes in which each transaction constitutes a completed event, whereas hierarchical and bilateral governance both view relationships as having a time dimension beyond individual transactions. For example, bilateral governance is based on entirely open-ended relationships, with no finite or foreseeable termination points (Macneil 1978). In its pure form of complete vertical integration, hierarchical governance also can involve essentially open-ended interactions. Conceivably, however, interfirm contracts can include an explicit statement of relationship commencement and termination, as is frequently the case with certain types of joint ventures (Dwyer, Schurr, and Oh 1987) and logistics alliances (Bowersox 1990). Alternatively, relationship duration need not be made explicit per se, though one party can provide in advance for the ability to unilaterally renegotiate or terminate the relationship, as is frequently the case with franchising contracts (Brickley and Dark 1987; Rubin 1990).

Three recent studies have examined the antecedents of relationships' time dimension. Joskow (1987) in a study of the structure of contracts between coal suppliers and electric utilities, found the existence of transaction-specific assets to give rise to the use of contracts with longer formal duration. In another study, Heide and John (1990) demonstrated that the expectations of open-ended interaction between buyers and suppliers were influenced positively by the supplier's investments in buyer-specific assets. Similar results were obtained by Anderson and Weitz (1990).

Empirical Test

In this section, I present the results of a preliminary empirical test designed to examine one particular aspect of bilateral governance. Consider as a starting point the conditions under which bilateral governance can emerge in general.

In the extant sociological literature (e.g., Granovetter 1985), bilateral interaction patterns are viewed as inherent properties of particular social structures. In its pure form, bilateral governance is essentially a cultural phenomenon (Simon 1991) or a by-product of social similarity (Zucker 1986) or preexisting familiarity and friendship (Bradach and Eccles 1989; Gambetta 1988). As such, no account is

generally given in this literature of its antecedents, besides extensive socialization efforts or prolonged exposure to a common set of values.

For present purposes, the key issue is whether bilateral structures can be crafted purposely in relationships between parties who possess inherently individual orientations. In general, this can be accomplished by crafting a *self-enforcing agreement* (Klein and Leffler 1981; Kreps 1990) or an incentive structure that makes the expected gains from maintaining the relationship exceed the potential short-term gains from opportunism or defection (Telser 1980).

One strategy for creating a self-enforcing agreement is for the parties involved to make "credible commitments" to the relationship (Williamson 1983, 1985), for example, by means of investments in dedicated assets (Anderson and Weitz 1992). In theory, commitments can be made in a unilateral fashion, either offered by one firm as a performance guarantee (Rubin 1990) or extracted as a "hostage" to enforce contractual compliance (Klein 1980). However, a bilateral relation also can be crafted by means of a reciprocal "hostage exchange," in which two parties make "separate but concurrent investments in specific assets" (Williamson 1983, p. 532). Under such a scenario, the "hostages" in question are never really exchanged. Instead, each individual party will retain ownership of its asset in the event of relationship termination (Williamson 1983).

The effect of such commitments is to create a locked-in condition (Katz 1989), which in turn promotes behaviors that ensure the continuance of the relationship. By making a commitment of this nature a "quasi-rent" stream (Klein, Crawford, and Alchian 1978) is created, which will be lost in the event of termination. Bilateral governance is promoted under such conditions because both parties have constrained the alternatives open to them, by virtue of making the exchange partner irreplaceable, or replaceable only subject to switching costs. In effect, a dependence condition exists (Barney and Ouchi 1986), which, if balanced or symmetric, represents a mutual safeguard (Williamson 1983, 1985) and a collective incentive to maintain the relationship (Oliver 1990).

The general incentive to maintain the relationship can manifest itself in different ways. One specific outcome of symmetric dependence is that the parties will have a joint motivation to show "forbearance" (Buckley and Casson 1988; Williamson 1991a) or flexibility in response to changing circumstances. In the absence of symmetric dependence, an individual party will have little or no incentive to show flexibility, because no guarantee exists that such actions will be reciprocated. In fact, short-term disturbances might represent an opportunity for individual parties to pursue opportunistically short-term advantages. However, the existence of symmetric dependence serves to align the respective parties' interests and promotes flexibility as a means of preserving the relationship (Macneil 1978). We propose the following hypothesis:

H₁: Symmetric and high dependence will lead to bilateral governance in the form of flexible adjustment processes.

It is noteworthy that this hypothesis makes no assumptions about the respective parties' cognitive orientation toward the relationship. The effect of creating a condition of symmetric dependence is to put in place an incentive structure that makes opportunism irrational, even for parties who are basically egoistic (Bradach and Eccles 1989).⁸ As such, behaviors can be observed in a relationship that resemble altruism but in reality are more a matter of norm formation than true identification with the other party (Bonoma 1976). In essence, a condition has been created that produces "similarity of selfish interests" (Macneil 1981, p. 1034) and reduces the need for altruism or exogenous norms of cooperation (Axelrod 1984; Gambetta 1988).

It is noteworthy, however, that for dependence to promote bilateral governance, the dependence condition somehow must be symmetric. To the extent that dependence exists unilaterally in a given situation, it actually could undermine efforts to develop a bilateral pattern of interaction (Buckley and Casson 1988; Oliver 1990). Using our previous example, to the extent that only one party to a relationship makes a commitment, an expropriation hazard exists (Williamson 1983), in the sense that the other party has an opportunity to extract the first party's profits (Porter and Fuller 1986). In fact, Anderson's (1988) finding of a positive relationship between transaction-specific assets (i.e., a cause of dependence) and opportunism is indicative of such a sequence of events. The potential for opportunism will represent a disincentive for the dependent party to show forbearance or flexibility in the first place. Thus, to the extent that dependence exists unilaterally in a given situation, it is predicted to have a negative effect on bilateral governance. Therefore:

H₂: Unilateral dependence by an individual party will decrease bilateral governance in the form of flexible adjustment processes.

The hypotheses were tested empirically in the context of relationships between industrial component manufacturers and their downstream OEM customers. A detailed description of research context, sampling, and data collection procedures is provided by Heide and John (1992).

Measures

The focal dependent variable, flexible adjustment processes, was measured by a set of items describing the parties' expected flexibility in response to changing circumstances. The FLEX scale was based on previous items developed by Kaufmann and Stern (1988). The main independent variable, dependence, was measured in terms of the ease with which an individual exchange partner could be replaced, in accordance with Emerson's (1962) conceptual definition. Specifically, the buyer's dependence on the supplier was measured by a four-item scale describing his or her ability to replace the supplier (REPSUP) and the supplier's de-

⁸The situation is somewhat similar to the one in which a set of parties play a repeated set of "Prisoner's Dilemma" games. In that case, the "shadow of the future," or expectations of future interactions, creates a self-enforcing agreement that may promote cooperation, as opposed to defection, on any given play of the game (Axelrod 1984).

TABLE 2
Multi-Item Scales

*Buyer Dependence (REPSUP)*¹ $\alpha = .79$

(4 items, 7-item Likert Scale, "Strongly Disagree—Strongly Agree")

1. If we decided to stop purchasing from this supplier, we could easily replace their volume with purchases from other suppliers.
2. There are many competitive suppliers for these components.
3. Our production system can be easily adapted to using components from a new supplier.
4. Dealing with a new supplier would only require a limited redesign and development effort on our part.

*Supplier Dependence (REPBUY)*¹ $\alpha = .82$ (4 items, same scale format as "Buyer Dependence")

1. If we stopped buying from this supplier, they could easily replace our volume with sales to some other buyer.
2. It would be relatively easy for this supplier to find another buyer for these components.
3. Finding new buyers for these components would not have a negative impact on the price this supplier can charge.
4. If the relationship with our company was terminated, it would not hurt this supplier's operations.

Flexibility (FLEX) $\alpha = .73$ (3 items, 7-item scale "Completely Inaccurate Description—Completely Accurate Description")

1. Flexibility in response to requests for changes is a characteristic of this relationship.
2. The parties expect to be able to make adjustments in the ongoing relationship to cope with changing circumstances.
3. When some unexpected situation arises, the parties would rather work out a new deal than hold each other to the original terms.

Three-factor measurement model: $\chi^2 (41) = 60.56 (p = .025)$

Bentler's Comparative Fit Index (CFI): .96

Average Off-Diagonal Standardized Residual (AOSR): .046

¹All items are reversed

pendence on the buyer by a four-item scale describing his or her ability to replace the buyer (REPBUY). The items used to measure replaceability were based on the ones originally used by Heide and John (1988). The items and scale formats are shown in Table 2. In addition to the theoretical variables of interest, four other measures were included in our analysis for model specification purposes: the degree of customization of the product in question (CUST), the degree of automation of the OEM's manufacturing operation (MANUF), the OEM's annual purchase volume from the supplier (\$PURCHASE), and the past length of the supplier-OEM relationship (LENGTH). Eventually, these four measures were used as control variables in the statistical model.

The multi-item measures (FLEX, REPSUP, and REPBUY) were subjected to a confirmatory factor analysis to verify unidimensionality. As shown in Table 2, a three-factor model estimated using EQS (Bentler 1989) shows good fit to the data ($\chi^2 (41) = 60.56 (p = .025)$, Bentler's Comparative Fit Index (CFI) = .96, Average Off-Diagonal Standardized Residual (AOSR) = .046). Moreover, a series of chi-square difference tests on the respective factor correlations provide evidence of discriminant validity. Finally, the coefficient alphas for the item sets show satisfactory evidence of reliability.

Two additional construct validity tests were carried out prior to the test of the substantive hypotheses. First of all, the multi-item measures of dependence were compared with a very dissimilar dependence measure, namely, the estimated number of months required to replace the other party. Both correlations are positive and significant as expected ($r = .39, p < .001$ and $r = .40, p < .001$ for the buyer's and supplier's dependence, respectively), providing evidence of convergent validity. Finally, the OEM's report for the different measures was compared with a parallel re-

port obtained from a key informant in the supplier's firm. The average correlation for the set of measures is .40 ($p < .001$), providing additional evidence about the quality of the measures.

Hypothesis Tests

The substantive hypotheses were tested by estimating an ordinary least squares regression model in the OEM sample. The model involved regressing flexibility against the two dependence variables, the interaction between the dependence variables, and the four control variables. The interaction term provides a test of the symmetry hypothesis (H_1), whereas the two main effects for the dependence variables provide a test of H_2 . In the presence of an interaction, a main effect is interpreted as the effect of a particular variable when the variable with which it interacts is 0 (Marsden 1981). In this case, the main effects provide information about the effects of unilateral dependence, or the effect of one party's dependence under conditions when no dependence exists for the other party.

The estimated model is shown in Table 3. As can be seen, the interaction term is positive and significant ($t = 3.25, p < .001$), showing that symmetric and high dependence promotes flexibility, in accordance with H_1 . Moreover, both of the main effects are negative and significant ($t = -3.65, p < .001$ and $t = -2.31, p < .01$, respectively), providing evidence that unilateral dependence in fact undermines flexibility, as per H_2 . As can be ascertained by inspecting the partial derivatives of the flexibility equation with respect to each dependence variable, an individual party's dependence has a negative effect on flexibility under conditions when the other party's dependence is low.

The results of the control variables show that flexibility is influenced positively when the product in question is cus-

tomized ($t = 2.94, p < .01$) and the relationship involves large purchase volumes ($t = 2.49, p < .01$). As might be expected, increases in the degree of automation in the buyer's manufacturing operation tends to decrease relationship flexibility ($t = -2.85, p < .01$). No significant effect was found for past relationship length.

Discussion

The pattern of results warrants some discussion. Specifically, our findings show that though symmetric dependence promoted bilateral governance, unilateral dependence in fact had negative effects. Thus, though the extant literature frequently discusses dependence in general terms, our results show that the specific pattern of dependence that characterizes a relationship has implications for how it is organized. Specifically, for dependence to give rise to a bilateral pattern of interaction both parties somehow must be locked into the relationship.

Some limitations of this research should be pointed out. First, no formal attempt was made to identify the antecedents of the dependence conditions. Though I suggested that investments in physical assets could have such effects, there are a variety of ways in which parties can become locked into a relationship. For example, Katz (1989) suggests that in a manufacturer-dealer setting the pricing provisions employed by the manufacturer (i.e., certain combinations of wholesale prices and franchise fees) can create an "artificial" relationship-specific asset on the part of the dealer. Another strategy suggested by Katz is to impose exclusive dealing arrangements on the dealer to link the dealer's reputation with the manufacturer's product line and thereby establish a relationship-specific dealer asset. Thus, though the present study was limited to measuring dependence directly, further research could be directed usefully toward examining the manner in which such conditions arise.

Furthermore, though the results show unilateral dependence to undermine bilateral governance, the present research does not address which forms of governance can be used under such conditions. One possible response could be unilateral or hierarchical governance. Recall that the effect of unilateral dependence is to create a safeguarding problem (Klein, Crawford, and Alchian 1978), which requires that mechanisms be designed explicitly to reduce the exposure to opportunism. Unilateral governance can be implemented in such a situation by means of explicit contractual provisions that simulate the effects of organizational hierarchies (Klein, Crawford, and Alchian 1978; Stinchcombe 1985). According to Williamson (1991b, p. 80–81), firms are expected to "anticipate potential dependency conditions and organize with respect to them from the outset."

It should be noted, however, that this prediction could be contingent on the party at risk possessing a sufficient amount of bargaining power to extract the necessary safeguards. If that is not the case, the safeguarding problem can be managed by somehow balancing the dependence structure itself (e.g., Heide and John 1988) to establish a disincentive for opportunism in the first place.

TABLE 3
Estimated Model
Dependent Variable: Flexibility (FLEX)

Independent Variables	Unstd. Coefficient	T-value
Constant	6.49	11.99**
REPSUP	-.56	-3.65**
REPBUI	-.30	-2.31*
REPSUP* REPBUI	.12	3.25**
CUST	.14	2.94*
MANUF	-.19	-2.85*
\$PURCHASE	.001	2.49*
LENGTH	-.001	-.71
R ² adj.: .14		
F (7, 141) = 4.34		

* $p < .01$
** $p < .001$

Theoretical Implications and Further Research

The main premise of this article is that there are conceptually three ways of organizing interfirm relationships. In contrast with much of the extant literature, which tends to view departure from market governance in terms of movement along a single continuum, I view nonmarket governance as a heterogeneous phenomenon, which can be accomplished in a unilateral and a bilateral fashion. Using a contracting metaphor (Stinchcombe 1990; Williamson and Ouchi 1981), exchange problems can be handled through "hard" or "soft" contracting, respectively. I have attempted to show, however, that distinctions among governance forms must be made with reference to specific governance processes. Essentially, the three governance forms presented are second-order constructs, and are defined in terms of particular constellations of processes, such as relationship initiation, maintenance, and termination.

I must emphasize, however, that the three governance types are "ideal types" (in a Weberian sense) of approaches to relationship governance. Ideal types are theoretical inventions employed to identify the elements most characteristic of a particular phenomenon (Scott 1987). By definition, ideal types are simplifications of more complex phenomena. Two particular points need clarification in this respect.

First, though the three governance forms discussed are distinct, they are not necessarily independent (Bradach and Eccles 1989). Within a given relationship, processes from different governance forms can be combined in different fashions. For example, franchisors frequently combine extensive socialization efforts with explicit *ex post* monitoring. Thus, many actual channel relationships can be viewed most appropriately as hybrid organizational forms like "clan-assisted markets" or "clan-assisted bureaucracies" (Barney and Ouchi 1986).

Second, though the previous discussion focuses on organizing individual relationships, evidence suggests that individual relationships are embedded in a context of other relationships that could have governance implications. Specif-

ically, Bradach and Eccles (1989) have shown how firms deliberately can combine different forms into a single system of "plural governance" to play the governance properties of different forms against each other.

Consider as a starting point the use of market governance, exemplified by the use of manufacturers' agents. As recognized in the extant literature, market governance could offer a firm a number of advantages, including scale economies and "high-powered incentives" (Williamson 1985). However, these benefits could come at the expense of potential governance problems, for example, in the form of monitoring difficulties. Conceivably, such problems can be managed by simultaneously deploying an alternative governance form. For example, adding direct salespeople (i.e., hierarchical governance) to a system of independent agents, even on a limited basis, could provide a firm with a standard for evaluating agent performance, as well as knowledge about which aspects of the agents' operations to monitor in the first place. As such, if operated in parallel with another governance form, market governance can be employed under conditions in which it by itself would involve transactional difficulties. A recent study by Bergen and colleagues (1993) shows preliminary evidence of this.

Note that governance in a plural system is achieved in an indirect fashion, by means of bringing the governance properties of one form to bear on another. In contrast, much of the previous discussion focuses on managing governance problems directly, by organizing a focal relationship in a certain fashion. It is unclear on the basis of the existing literature what the relative merits of the two approaches are. For example, it is unclear whether a strategy of adding company salespeople to a system of independent dealers is preferable to a strategy of subjecting the relevant dealers to direct socialization efforts (e.g., Ouchi 1979). Holding cost and governance considerations constant, we would suspect that a system of plural governance could represent strategic advantages, in the form of an inherent flexibility to respond to competitive moves and changes in consumer preferences. It is hoped that additional research will be directed toward exploring these issues.

The preceding discussion suggests a number of additional avenues for further research. First a number of the governance dimensions, such as initiation and enforcement, to date have been subject to only limited empirical inquiry. Furthermore, the determinants of plural governance structures and the performance implications of different governance strategies are virtually unexplored in the existing literature.

Furthermore, the governance trichotomy contains a series of implicit research hypotheses that can be explored empirically. For example, the three governance forms differ in their general approach to managing relationships. Market governance relies primarily on the design of an incentive structure for obtaining certain behaviors, whereas hierarchical and bilateral governances rely on a combination of rules and monitoring and socialization efforts, respectively. Though individual mechanisms in practice will be combined, as mentioned previously, these three general approaches to governance are at the same time "generic" in the sense that they can substitute for one another. For exam-

ple, extensive socialization efforts are likely to reduce the need for ongoing monitoring, as can appropriately crafted incentive systems (Rubin 1990). Additional research could be directed usefully toward examining whether these relationships are supported empirically and whether particular situations are more efficiently handled by selection/socialization than by monitoring or incentive structuring.

Finally, research could be directed usefully toward exploring the dynamics involved in organizing interfirm relationships (Ring and Van de Ven 1992). For example, the particular history of a relationship could serve as a constraint on subsequent attempts to develop particular types of governance. Specifically, it could prove dysfunctional to introduce unilateral elements into a relationship that traditionally has been governed on a bilateral basis, because the very nature of unilateral governance could violate the norm on which the original relationship was established. It is hoped that further research will explore some of these issues in more detail.

Managerial Implications

Perhaps the main implication of this article for managerial decision making is that it identifies a series of dimensions along which interfirm relationships can be structured. Specifically, we view the governance dimensions discussed previously as strategic decision variables in their own right, which can be made subject to deliberate design. Though many of the extant models of channel strategy tend to emphasize choices among discrete channel types (i.e., integration versus nonintegration), I would argue that it is the nature of these specific dimensions, rather than channel types per se, that represent the ability to manage ongoing relationships. In fact, as evidenced by Dwyer and Oh's (1988) findings, governance dimensions are not isomorphic with channel type or institutional arrangement. On a similar note, the use of general terms like "partnerships" and "alliances" is potentially misleading. First, such terms are used frequently to describe a generic departure from market governance and an implicit move toward hierarchical governance. The main premise of the preceding discussion is that nonmarket governance cannot be described by a single continuum. Furthermore, global terms like these tend to obscure the nature of the actual interfirm processes that take place.

Second, the preceding analysis of governance forms highlights some basic strategies for establishing and managing channel relationships. For example, to obtain certain behaviors from franchisees, a franchisor fundamentally can choose between crafting an appropriate incentive structure by means of some combination of initial fees and royalty payments (Rubin 1990), developing a hierarchical system of rules and *ex post* monitoring (Stinchcombe 1985), selecting compatible channel members who subsequently can be subjected to socialization efforts (Ouchi 1979), or creating enforcement devices by means of requiring franchisees to make investments in brand-specific capital (Klein 1980).

Choices among governance forms will have to be made based on a joint assessment of setup cost, ongoing governance costs, and potential opportunity costs, resulting from a potential mismatch between the nature of the situation at

hand and the features of the selected governance mechanisms. For example, the initial cost of establishing “true” bilateral governance could exceed the setup cost for a bureaucratic structure but could economize on ongoing governance efforts because monitoring needs would be reduced. However, to the extent that initial socialization efforts are ineffective, a failure to engage in systematic monitoring efforts represents exposure to opportunism.

We should emphasize that much of the preceding discussion is based explicitly on efficiency considerations. Specifically, we have discussed governance issues primarily from the perspective of designing interfirm structures that economize on certain types of governance costs. Clearly, firms make governance choices based on a variety of criteria, and in a given situation, the efficiency line of reasoning presented here must be considered jointly with strategic issues,

such as a desire to deter market entry or achieve product differentiation. It is noteworthy, however, that besides the traditional scale economy considerations, efficiency appears to be a poorly understood concept.⁹ As a matter of fact, many of the extant managerial decision models emphasize effectiveness criteria and evaluate channel arrangements primarily in terms of their ability to accomplish certain functions per se. As a concluding comment, I argue that depending on a firm’s strategic profile (Porter 1985), efficiency considerations can be very important, in some instances more important than control per se (Cespedes 1988, Lambert 1966). As such, the types of governance issues raised here should be considered explicitly.

⁹See Williamson (1991b) for a discussion of the role of efficiency considerations in developing business strategy.

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