Interfirm Dyadic Governance:

Integrating Perspectives of Relational Orientation and Power Dependence

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ABSTRACT: This paper suggests a framework of interfirm dyadic governance with considerations of power dependence and relational orientation of the exchange partner. I argue that different forms of dyadic governance should be employed by a firm when facing a variety of exchange partners with different power dependence and different orientation towards the relationship. The framework furthers the discussions of interfirm dyadic governance and helps practitioners evaluate their relational strategies towards various exchange partners. The management of a portfolio of exchange partners could serve as a basis for competitive advantages.

Key Words: inter-organizational relationships, strategy, competitive advantage, exchanges and relationships

The value chain in modern economies is characterized by interfirm specialization such that individual firms engage in a narrow range of activities that are embedded in a complex chain of input-output relations with other firms. (Dyer 1997)

With the prominent existence of interfirm relationships in modern economies, researchers have devoted considerable attention to exploring, developing, and testing models of interfirm relationships (e.g. Heide 1994; Dyer 1997; Narayandas & Rangan 2004; Heide & Wathne 2006). Specifically, a substantial body of literatures has focused on the discussion of distinctive governance forms or mechanisms involved in interfirm governance decisions, such as contract (e.g. Ness & Haugland 2005) and trust (e.g. Jeffries & Reed 2000). For example, Narayandas & Rangan’s (2004) empirical exploratory study discovered different forms of governance among three dyads of suppliers and buyers with different initial power asymmetries.

Yet, in real world, a firm usually faces a variety of exchange partners with a mixture of
trade-related characteristics, such as power dependence and relational orientation. A comprehensive framework is needed to suggest suitable mechanisms or forms of interfirm dyadic governance considering different contexts.

The purpose of this paper is to suggest a preliminary but more comprehensive framework of interfirm dyadic governance, integrating the perspectives of relational orientation (Heide and Wathne 2006) and power matrix (Cox 2001).

**LITERATURE REVIEW**

**Interfirm Dyadic Governance**

This paper defines interfirm dyadic governance as ‘a select, persistent, and structured set’ of two ‘autonomous firms engaged in creating products or services based on implicit and open-ended contracts to adapt to environmental contingencies and to coordinate and safeguard exchanges.’ (Jones, Hesterly, Borgatti 1997) The definition was borrowed from the definition of network governance, proposed by Jones, Hesterly, Borgatti (1997).

In literatures, several paradigms have been invoked to explicate interfirm dyadic governance. Specifically, transaction cost economics theory (Williamson 1975) and resource dependence theory (Pfeffer 1972) have been adopted to explore the nature of interfirm dyadic governance (e.g. Heide 1994). Relational contracting theory (Macneil 1980) was introduced to understand the range of interfirm dyadic governance forms (i.e. Lusch and Brown 1996). Besides, social exchange theory (Blau 1968) was brought in to interpret the process of interfirm relationship development and
maintenance (i.e. Lambe, Wittmann, and Spekman 2001).

**Forms or Mechanisms of Interfirm Dyadic Governance**

Based on TCE logic, Jones, Hesterly, and Borgatti (1997) proposed that interfirm governance forms must ‘address problems of adapting, coordinating, and safeguarding exchanges more efficiently than other governance forms.’ In literatures, the most widely discussed interfirm governance form was contract (Williamson 1985; Ness & Haugland 2005). A legal contract denotes ‘the obligations of each party and allows a transactor or to go to a third party to sanction an opportunistic partner’. (Dyer 1997) Other forms discussed in literatures include, trust (Sako, 1991; Jeffries & Reed 2000), specialized investment hostage (Williamson 1983; Loranzoni & Lipparini 1999), reputation (Kreps and Wilson 1982; Weiget and Camerer 1988), financial hostage (Klein 1980), etc... Each form has its benefit and limitation. For example, ‘reputation safeguards exchanges because it relays the detection of and serves to deter deceptive behavior, which enhances cooperation…. Reputations have limitations in their use. For instance, information about reputation may be inaccurate or misinterpreted….over-reliance on reputation may reduce new and innovative information as actors limit their range of partners.’ (Jones, Hesterly, and Borgatti 1997)

Regarding mechanisms of interfirm dyadic governance, Heide and Wathne (2006) proposed four general governance mechanisms, including selection, socialization, incentives, and monitoring.

*Selection: Relationship governance through selection involves identifying exchange partners a priori that exhibit a good fit on particular criteria.* … *Socialization: Socialization is the process*
by which new parties learn skills and internalize another party’s values, goals, and rules. …

Incentives: In general, the rationale for the use of incentives is to structure a relationship in such a way that particular actions are explicitly rewarded or punished. … Monitoring: Monitoring involves explicit measurement of partner performance relative to some preexisting agreement or standard. (Heide and Wathne 2006)

Diverse governance mechanisms may reveal different signals to exchange partners, such as ‘clanlike’ or ‘harder’ (Heide and Wathne 2006). Heide and Wathne (2006) suggested that ‘firm’s governance decisions must be made in a context-sensitive manner.’

Orientation of Interfirm Relationship

Regarding the orientation of interfirm relationship, there have been two main streams of literatures – institutional economics and sociology. From perspectives of institutional economics, firms are assumed to seek utility maximization and the orientation of firm’s relationship behavior is ‘calculative’ (Williamson 1994; Heide and Wathne 2006). From sociological perspectives, interfirm relationship behaviors follow from ‘heuristic’, which refers to ‘the decision-making processes that economize on cognitive resources, time, and attention processes but do not necessarily jeopardize the quality of decisions’ (Uzzi 1997; Heide and Wathne 2006). The implicit assumption for both streams of research is that firms in a dyadic relationship have global characteristics, either ‘calculative’ or ‘heuristic’, towards the exchange partner. Some scholars have challenged this view of the fixed traits of firms in a dyadic relationship (Heide & Wathne 2006). It is established in this paper that relational
orientation is a matter of relativity, either ‘more calculative’ or ‘more heuristic’. In addition, a firm may show different relational orientation in diverse dyadic relationships.

**Interfirm Power**

Emerson (1962) proposed that ‘the basis for one party’s possession of power in a dyadic relationship lies in the other party’s dependence’. Frazier (1983) defined interfirm power as the ability of one firm to influence ‘decision variables’ of another firm. Some scholars introduced the power paradigm to grant its consequences on trust and commitment among exchange dyads (Narayandas & Rangan 2004). Narayandas and Rangan’s (2004) exploratory research suggested that ‘weaker firms can structure and thrive in long-term relationships with powerful partners because initial asymmetries of power were subsequently redressed through the development of high levels of interpersonal trust across the dyads, which in turn leads to increased levels of interorganizational commitment.’

Regarding the framework of interfirm power, Cox, Sanderson, & Watson (2000) proposed a power matrix around the idea that ‘all buyer and supplier relationships are predicated on the relative utility and the relative scarcity of the resources that are exchanged between the two parties.’
A FRAMEWORK OF INTERFIRM DYADIC GOVERNANCE:

In this section, a preliminary framework is developed to specify how different forms or mechanisms of interfirm dyadic governance may be leveraged under conditions of different power dependence and relational orientation. In developing the framework, the extant framework of power matrix (Cox, Sanderson, & Watson 2000) and orientation of relationships (Williamson 1994, Uzzi 1997) are integrated. The power matrix is used as a fundamental classification a firm (focal firm) faced in a dyadic relationship. Figure 1 depicts the framework, which uses buyer-supplier relationship as an example and suggests forms or mechanisms from supplier’s perspective.
Figure 1: Framework of Interfirm Dyadic Governance (from supplier’s perspectives in a buyer-supplier relationship): integrating power dependence and relational orientation

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Buyer Dominance Situation

Buyer dominance is a situation where the buyer has relatively higher power than the supplier in a dyadic buyer-supplier relationship. From supplier’s point of view, how to make sure the buyer would continue the relationship is the key concern of the interfirm dyadic governance. If the buyer is more ‘calculative’ oriented (Williamson 1994), the supplier could offer specialized investment as incentives, such as building just-in-time warehouse, to create lock-in effects. Specialized investment would ‘hold up’ the buyer by increasing buyer’s switching cost to other suppliers (Hennart, 1991). On the other hand, facing a buyer with more ‘heuristic’ orientation, the supplier can emphasize on building interpersonal trust, through socialization, with the buyer. Narayandas & Rangan’s (2004) empirical exploratory study among three dyads of suppliers and buyers with different initial power asymmetries indicated that weaker supplier can survive in long-term relationships with powerful buyer through the development of high levels of trust across the dyads.

Supplier Dominance Situation

Supplier dominance is a situation, in which the supplier has relatively higher power over its buyer. Cox (2001) proposed twelve fundamental bases for a powerful supplier, including ‘legal property rights, economies of scale, information impactedness, causal ambiguity, reputation effects (brands), buyer switching costs, buyer search costs, network effects, collusive cartels, lack of substitutes, lack of threat of backward integration, lack of disintermediation threat.’ In the supplier dominant situation, facing a buyer with more ‘calculative’ orientation, a supplier can impose financial hostage, as
incentives, because there are likely to be economics of scale in the supply side (Klein 1980).

Alternatively, when facing a more ‘heuristic’ buyer, a supplier can continuously emphasize on its reputation through socialization process. A powerful supplier’s reputation is a big incentive for a weaker buyer to stay in the relationship with because reputation represents a ‘quality signal’ from interorganizational cognitive perspectives (Porac, Ventresca, and Mishina 2002). In addition, if the buyer is not as well-known as the supplier, association with a famous supplier may help the buyer enhance its reputation. Therefore, facing a more ‘heuristic’ and weaker buyer, who tends to rely on socialization as a main mechanism to interact with the supplier, a supplier can continuously stress on its reputation through the socialization process.

**Interdependence Situation**

Interdependence is a state where both the supplier and the buyer have high power in the dyadic relationship. Under this situation, when facing a more ‘calculative’ oriented buyer, the best way that a supplier can do is to sign explicit contracts (Klein 1980). Monitoring is the mechanism that a supplier can employ to prevent opportunistic behaviors. On the other hand, while facing a buyer with more ‘heuristic’ orientation, a supplier can consider build partnership to enhance the relationship. Selection is the key mechanism for the supplier to find a ‘friend’ with synthetic effect (Heide & Wathne 2006).

**Independence Situation and Supplier’s Interfirm dyadic governance**

Independence is a state, mostly in a perfectly competitive market, that both the supplier and the buyer have low power in a dyadic relationship. In this situation, the best governance form for the
supplier, as well as for the buyer, is the market.

CONCLUSIONS AND IMPLICATIONS

Although there have been extensive literatures about forms and mechanisms of interfirm dyadic governance (Heide 1994; Dyer 1997; Loranzoni & Lippinini; Jeffries & Reed 2000; Ness & Haugland 2005), a comprehensive framework is needed for practitioners facing various exchange partners with different power dependence and relational orientation. This paper suggests a framework that integrates the interfirm dyadic governance paradigm with the relational orientation and the power paradigm.

It is worth of note that the framework proposed by this paper was developed from a supplier’s point of view. The governance form and mechanism in the context of interdependence and independence might be applied to buyer side as well. However, in the situation of buyer dominance or supplier dominance, there might involve more complex decisions for a buyer. For example, a buyer might decide to do nothing in terms of governance in a buyer dominance situation or try to find alternative ways, such as investigating new materials, to escape from being locked to a specific supplier in a supplier dominance situation.

Research and Managerial Implications

Although some scholars have suggested frameworks regarding the governance type of a whole value chain (i.e. Gereffi, G., Humphrey, J., and Sturgeon, T. 2005), the framework proposed in this paper still have a concept appeal in terms of looking into the dyadic relationship in the value chain and
corresponding governance type in each dyadic relationship. In practice, the framework would help
supply-side managers evaluate their relationship management strategies, especially about the
appropriateness of the forms and mechanisms used to manage the relationship with various buyers with
different trade-related characteristics.

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