

2.7 THE IMPORTANCE OF GOVERNANCE IN SUPPLY CHAINS INVOLVING SMALLHOLDER FARMERS

Humphrey and Schmitz (2002) view governance to involve coordination and include the act of parameter setting and enforcement. Governance arises when non market co-ordination of activities along the supply chain is required, whereby agents at one point in the chain set the parameters followed by agents at one or more other points in the chain. They argue that the main parameters defining the activities of a supply chain include:

- *What is to be produced?* This involves the design of products, both in broad conception and detailed specifications.
- *How it is to be produced?* This involves the definition of production processes, which can include elements of technology to use, quality systems, labour and environmental standards.
- *Physical product flow.* How much is to be produced, when and how the flow of product along the chain is to be handled.

The product specifications arise when manufacturers make products with integral design and require high level of customised components or when the buyer has a better understanding of the demands of the market than the supplier. Hence, the buyer interprets the market and informs the supplier of what is required. The specification of process parameters is a result of risks. For instance, potential losses along the chain arising from failure of participants to meet commitments (for example, delivering the right product on time) or failure to meet certain product or process standards (ibid.).

The issue of governance in value chains cannot be overemphasised. The main reasons for supply chain governance according to Humphrey and Schmitz (2002) include:

- *Access to market.* Smallholder producers need to access lead firms in the supply chain. These lead firms undertake the functional integration and coordination of internationally dispersed activities (Gereffi, 1999). Decisions taken by these lead firms may result in some of the producers losing out. Humphrey and Schmitz (2002) point out that research in the horticulture industry in the United Kingdom and Africa suggest that smallholder growers are marginalized and the main reason appear not to

be because of the efficiency advantage of large producers, rather because of the lead firms' sourcing strategies, which are influenced by consumers' expectations, safety and environmental requirements by governments and non-governmental organisations, as well as labour standards.

- *Fast track to acquisition of production capabilities.* Smallholder producers who gain access to supply chains find themselves in a steep learning curve, because the lead firms tend to be too demanding in terms of cost reduction, raising quality standards, and increase in delivery speed. However, these firms do transmit best practises and provide advice (though accompanied with pressure). Therefore, highly governed chains are characterised by such kind of challenges.
- *Distribution of gains.* Understanding the governance of the supply chain helps in understanding the distribution of gains between the supply chain members. Although subject to systematic verification within the supply chain, these governance related issues play a critical role in the debate, whether there is a fair spread of gains among the supply chain members.
- *Leverage points for policy initiatives.* Because supply chains are not just strings of market relationships, they can undermine government policy but also offer leverage points for government initiatives aimed at smallholder farmers' development. However, governments and non-governmental organisations concerned with raising labour and environmental standards recognise these leverages.
- *Funnel for technical assistance.* Multilateral and bilateral donor agencies seek to find ways to provide effective technical assistance to developing country producers. As a result they try to foster trans-national corporations (TNC) and small, medium enterprises (SME) partnerships.

The main idea is to combine technical assistance with connectivity. Therefore, the lead firms become the entry point for reaching out to small and medium sized suppliers. Research has shown that some buyers may require mentoring in order to fulfil this funnel of transmission. In the UK for instance, supermarkets in the horticultural value chain play an important role in

targeting those buyers when considering promoting smallholder production of export horticultural crops (ibid.).

2.8 TRUST AS A GOVERNANCE MECHANISM IN EXCHANGE RELATIONSHIPS

2.8.1 Definition of trust

Trust is defined as the buyer/supplier's confident belief in the supplier/buyer's honesty towards the buyer/supplier (Morgan and Hunt, 1994). Trustworthiness and trusting behaviour are considered distinct, but related aspects of trust (Andaleeb, 1996). While trustworthiness refers to a belief (Anderson and Narus, 1990; Anderson and Weitz, 1989; Morgan and Hunt, 1994), trusting behaviour on the other hand is related to the engagement in risk-taking behaviour that reflects reliance on another partner (Moorman *et al.*, 1992). Both the belief and reliance aspects of trust indicate the importance of uncertainty and vulnerability to trust in buyer-seller relationships (Achrol, 1997; Doney and Cannon, 1997). Trust is considered to exist if one party believes that the other party is honest or benevolent (Doney and Cannon, 1997). It is the expectation that attenuates the suspicion that one party in the transaction will behave opportunistically (Gulati, 1995; Bradach and Eccles, 1989). Thus, if trust exists in a relational contract, the contracting parties will be convinced that they will not be victims of behaviour, such as adverse selection, moral risk, hold up or any type of contractual hazard.

2.8.2 Types of trust

Sako (1998) identified three types of trust. These include contractual trust, competence trust and goodwill trust. Contractual trust rests on a shared moral norm of honesty and promise keeping, while competence trust requires a shared understanding of professional conduct, technical and managerial standards. Goodwill trust can exist when there is consensus on the principle of fairness. She argues that there is a hierarchy of trust, whereby fulfilling a minimum set of obligations constitute contractual trust, while honouring a broader set constitutes goodwill trust. Therefore, a movement from contractual trust to goodwill trust involves a gradual expansion in the congruence of beliefs about what is acceptable behaviour. Hence, opportunism is not a mere opposite of trust. But the absence of opportunism forms the

bases for both contractual and goodwill types of trust. Sako (1998) further argues that a supplier withholding a vital piece of technical information may not be acting opportunistically according to the strict contractual sense, but fulfilling the spirit of the contract through commitment and fair behaviour, is close to goodwill trust.

Faulkner (1995) analysed trust into three types; calculative trust, predictive trust and friendship trust. Calculative trust develops when each party calculates that the other can help it, and hence trusts the other in the hope that matters will work out well. This type of trust is also referred to as calculus-based trust, which is based on the idea of rational choice between the trusting parties. It emerges when the trustor perceives that the trustee intends to perform an action that is beneficial to him. For example, when the farmer trusts the miller because he knows that the miller will be punished if he lets him down, but also because the farmer has information that the miller is competent in some sense, which is important for the farmer to trust the miller.

With predictive trust, each party believes that the other will behave as it says it will because it has kept its word in the past. Gulati (1995) referred to such trust as prediction based or knowledge based trust. It is the extent to which “the person who trusts “ can predict that the “person trusted” will act in good faith. This type of trust is a result of knowledge acquired about the responsible behaviour of the partners through repeated contact.

Friendship trust on the other hand develops when each party likes each other as individuals and therefore the trust takes on a more personal aspect. If this is also present, it is likely to make the relationship more robust and flexible when problems arise. This type of trust is similar to the goodwill trust. Medina-Munoz and Medina-Munoz (2002) referred to such trust as affection-based. It is based on the emotional links and bonds formed as a result of frequent interactions between participants in relational exchange. In the presence of affectional trust participants express; (1) a sincere interest in the prosperity of the partners, (2) a feeling that the relationship has inherent advantages, and (3) the belief that those feelings are shared. They argue that affectional trust reduces opportunistic behaviour.

In both cases the first two factors are about whether the other party can be trusted to be capable of achieving the desired result and if so, whether it can then be trusted to keep to its

word. These factors usually provide the basis for trust in more formalised relationships, which are bounded by rules, whether written or unspoken.

2.8.3 Sources of trust

Humphery and Schmitz (1998) identified three sources of trust, the institution-based trust, meso-level characteristic-based trust, and processed-based trust. Institutional based trust involves the use of institutional factors that can act as support for trust. It is generated by confidence in the 'formal structures' of society and more importantly in their ability to impose sanctions when trust is breached (Lane and Bachmann, 1996; Humphery and Schmitz, 1998). Examples of institution-based trust include the legal system and trade associations. Meso-level characteristic-based trust, is trust based on the characteristics or reputation of the transacting parties. Here group membership serves as an indication of trustworthiness, as is reputation. Trust derived from experience of co-operative interaction is referred to as processed-based trust. This form of inter-firm trust is built incrementally as firms repeatedly interact (Nohria and Gulati, 1996).

These three sources of trust can be hierarchically conceived in that they represent varying levels of trust. Institution-based trust, also referred to as 'minimal trust', is a necessary but not sufficient condition for the formation of co-operative trust-based relationships. The basis of long-term co-operative supply chain relationships is 'extended trust'. Extended trust is not confined to honouring explicit contractual obligations, but includes a demonstrated long-term commitment to building the supply chain relationship, i.e. processed-based trust. Building and maintaining extended trust relationships is a complex process. Moreover, this process is aggravated by asymmetries in firm size, which may exist in the supply chain. This is particularly relevant where a smaller firm, for instance the smallholder farmers, supplies a much larger dominant firm like the millers. In this case, the smaller firm is the more vulnerable partner. Consequently, the responsibility rests with the dominant firm to initiate a collaborative trust based relationship (Humphery and Schmitz, 1998). Similarly, the broader business or institutional environment in which firms operate can contribute or detract from the formation of trust-based relationships (Lane and Bachmann, 1996).

2.8.4 Trust as an economic asset

Generally, an asset is a resource that creates benefits for a firm and the value of an asset can be measured and it depreciates overtime. Assets also have an opportunity cost and can complement or substitute for another (Wilson and Kennedy, 1999). Welsch *et al.* (1976), as quoted by Wilson and Kennedy (1999), argue that even unidentifiable intangible assets such as goodwill can be purchased, amortized, and sold. They point at reputation as one determinant of goodwill. Such reputation may be valued with other contributors to goodwill as present value of the expected future earnings of the firm. Dasgupta (1988) uses game theory to illustrate the economic value of trust. He argues that trustworthiness is similar to other assets such as knowledge and information.

According to Lorenzen (1998), trust is of economic value because it allows agents to initiate and maintain cooperation without safeguards. He argues that if trust is common amongst the whole group of agents, widespread flexible cooperation is a real option. He further argues that the importance of trust for economic action and cooperation applies to both principal-agent relationships within firms, relationships between firms and customers and between managers and independent business firms.

Trust is considered of economic value when it is based on non-contractual, rather than contractual mechanisms. Non-contractual trust such as goodwill eliminates the need for formal contracts, which are costly to write, monitor, and enforce (Barney and Hansen, 1994; Dyer, 1997), and thus it reduces transaction costs. For example, in conditions of high trust, transactors spend less time and resources on ex-ante contracting because they trust that pay-off will be divided fairly. Thus, there is no need for future contingencies (Dyer, 1997). Trusting parties spend less time and resources on monitoring to see if the other party is not shirking or is fulfilling the spirit of the agreement. This is because parties have confidence that each party will not take advantage of the other even when there is a chance to do so. When there is high trust, transactors spend less time and resources on ex-post bargaining and haggling over problems that may arise during the transaction process. Therefore, trusting parties assume each party is acting in good faith and will interpret behaviours positively (Dyer, 1997; Uzzi, 1997). In addition to reducing transaction costs, trust also enable participants in an exchange relationship to share important confidential information and

encourage them to make relationship-specific investments, which in turn enhance productivity in the exchange relationship without fear of opportunism (Parkhe, 1993; Dyer, 1997).

2.8.5 Trust as a governance mechanism

Several scholars have long recognised the importance of trust in an exchange relationship (Gambetta, 1988; Frank, 1988; Macaulay, 1963). The importance of trust results from the impossibility of establishing complete contracts that account for all contingencies (Macaulay, 1963). Recently, it has been recognised that the role of trust goes beyond just complementing incomplete contracts, but actually playing an effective role as a governance mechanism (Barney and Hansen, 1994; Sako, 1992, 1998).

One way of viewing the supply chain is to see it as made up of a number of dyadic relationships. In this rather atomistic conception actors only meet for a specific contract to buy and sell, there is no memory and no social context. The dyad is a one-time link. The theoretical analysis of long term dyadic relations in the past decade has largely been based on a comprehensive contracting model, in which society is portrayed as being comprised of isolated, self-interested individuals where contract law supplies the needed glue to hold individuals to their bargains. Yet this comprehensive contracting view of the world is an unrealistic description of both business relationships and the legal practise of contract law.

Macaulay (1963) introduced an alternative view to the neoclassical theory of contracts. He maintains that the importance of law in contractual relations has been vastly overstated and he argues that economic agents construct productive relationships mainly without reference to the legal system (Macneil, 1985; Klein and Leffler, 1981). They use a variety of purely private mechanisms such as personal trust, calculative trust, reputation and constructed mutual dependence. The main issue between the relationship governance through legal institutions and trust lies in the relative roles of trust and law in promoting cooperation (Deakin, Lane and Wilkinson, 1997).

Sociologists such as Grief (1996) and Granovetter (1985) argue that relationships are embedded in a broader social structure. Therefore, social or network relations affect the nature of interactions between traders and they provide powerful enforcement mechanism when a potential for dispute exists (Galanter, 1974). Businesses rarely resort to legal

remedies and even when they do, they find that contract law is not interpreted according to classical principles. The assumptions of neo-classical discourses of economics and law with regard to contract have been challenged by many scholars in the sociological and socio-legal literatures (Lewis and Weigert, 1985; Mayer, *et al.*, 1995; Luhmann, 1988; Zucker, 1986; Campbell and Harris, 1993). In commercial reality, trusting and cooperative relations are the norm rather than the exception because the majority of businesses do not engage in 'single-games' (Antle, 1984) or in 'discrete' contracting (Macaulay, 1963; Macneil, 1974).

It has been argued that trust is a positive factor in business relationships and that the transaction cost among individuals interacting with each other is lower in high trusting relationships. The main reason for this is that the need to negotiate agreements is not as frequent in high trust relationships as in low trust relationships. Trust between firms designates the nature of the working relationship between the firms. Where a firm can trust its partner, both initial negotiations as well as on-going relationship negotiations are eased. The risk of opportunistic behaviour by the other partner is reduced in the presence of trust (Bradach and Eccles, 1989; Chiles and McMakin, 1996; Hill, 1990). Trust allows a firm to rely on the partner confidently (Moorman *et al.*, 1993). Trust has also been shown to relate to the incidence of constructive conflict resolution and to act as a substitute for other governance mechanisms such as contractual safeguards (Weitz and Jap, 1995; Gulati, 1995; Gundlach and Murphy, 1993; Heide, 1994; Parkhe, 1993; Ring & Van de Ven, 1992). It allows for exchange that otherwise would be hazardous to a partnering firm, such as that involving provision of sensitive technical information to an exchange partner (Gundlach *et al.*, 1995). Trust affects the confidence in partner cooperation and the interaction between trust and control influences the development and maintenance of partner relationship confidence (Das and Teng, 1998). Trust and authority measures have been shown to interact, such that where there is a history of trust, there is less need for authority since the potential for authority advantage to disrupt a relationship may be mitigated by the existence of trust.

2.9 THE SOCIAL CONTEXT OF RELATIONAL EXCHANGE

2.9.1 Power and dependence

In any business relationship the balance of power and the degree of dependence or interdependence will help shape the atmosphere of the exchange process and the relationship. In this study power is defined as the ability of one party to influence the actions of the other (Gaski, 1984). The perceived balance of power is what becomes important, since it is not the use of the power within the relationship, which can change the actions of the parties, but the knowledge that power exists. It is considered that the relative dependence between the parties in the relationship determines their relative power (Hallen *et al.*, 1991). Hence, the need in an analysis of an atmosphere to investigate not only dependence, but also the degree of mutual dependence between the parties.

If party A perceives that he/she is dependent on party B and that party B is not dependent on A, then that would give party B a certain degree of power in the relationship. However, party B would only have that power if they hold the same perception of power differences. This is where perceptions become very important in shaping the actions of the parties and therefore the shape of the relationship. In this study the relationship between cane growers and millers is shaped by the perceptions of each other relative to the power position of self and the other party. Dependence in the sugar industry may result from several factors, including lack of alternatives by cane growers and the importance of sugarcane to the millers.

Pfeffer and Salancik (1978) suggest that organisations respond to the demands of other organisations that control critical resources. From this, power and dependency may be seen as opposite on the same continuum in that firms in a business relationship can be expected to adapt to each other to the degree that they are dependent on each other's resources (Hallen *et al.*, 1991). In other words, if one party holds the balance of power based on control of critical resources then the other party may be dependent on that party.

2.9.2 Cooperation, dependence and competition

Cooperation and dependence are the two extremes of the same continuum, going from a desired bilateral investment in the relationship to a constrained maintenance of the

relationship from one of the two parties regarding the difficulty to replace his partner (Emerson, 1962; Dabholkar *et al.*, 1994). Cooperation between a customer and a supplier is based on balance, harmony, equity and mutual support (Oliver, 1990). It combines a very positive state of mind and a very positive behaviour on behalf of each party. Cooperation is a bilateral management where the two parties involve common investments and coordinated actions (Anderson and Narus, 1990; Wilson, 1995), voluntarily (Morgan and Hunt, 1994) with the objective of making a profit (Smith *et al.*, 1995).

Cooperation and competition are seen in most of the interaction literature as being opposite along the same continuum as in the power and dependency situation. In simple terms, cooperation is the willingness by both parties to work towards common benefits or an attitude towards work in common, and this work in common is seen as “tit-for-tat”, which inevitably gives benefit to both parties (Hallen and Sandstrom, 1991).

Competition on the other hand implies a lack of will to cooperate towards joint goals (Hallen and Sandstrom, 1991). Competition is not necessarily a negative influence on the relationship, but it may cause conflict in certain cases, which may be counterproductive in the development of the relationship. It is relevant therefore to look at both cooperation and lack of cooperation in assessing the atmosphere of relationships. More especially lack of cooperation, because it can cause a few problems, which may result in conflict. Reliance on perceptions in this regard is of importance since what one party may consider a problem the other party may not perceive as a problem or lack of cooperation. Hence, the perception of cooperation by millers and cane growers is vital in assessing their relationship.

Several studies have described the kind of actions and investments involved in cooperative relationships (Anderson and Narus, 1990; Dwyer *et al.*, 1987; Wilson, 1997; Mohr and Spekman, 1994; Morgan and Hunt, 1994). Even if there is reduced consistency between their results, it is clear that in all these studies the main effect of cooperative actions is to influence the behaviour of the parties, leading to a regular and stable relationship. Dependence may result to asymmetry of power between the two parties (Dwyer *et al.*, 1987; Geyskens *et al.*, 1996; Wilson, 1995). This asymmetry of power may exist from the customer towards his supplier or from the supplier towards his customer (Dabholkar *et al.*, 1994).

2.9.3 Trust and opportunism

Trust is often equated as being inversely proportional to opportunism. Williamson (1992) believes that trust is only warranted when the expected gain from placing oneself at risk to another is positive. Hence, the assumed unidimensionality of trust and opportunism. This behaviour can manifest itself in the exchange of goods, services, and information. Since trust in a relationship is built up overtime, close continuing relationships are regarded as being vital in generating trust and characteristics such as predictability of behaviour in terms of repetitiveness, reliability, competence and credibility are also considered important in generating trust in relationships (Wilkinson and Young, 1989). Therefore, these characteristics are essential in measuring trust, but also helpful in assessing the degree of trust and the existence of legal agreements as well as the degree to which these are used within the relationship. The measurement of trust and its effects on the relationship characteristics and development, are mostly based on some supposed aggregate value, as opposed to potentially differing perceptions of trust the parties may have about their relationship.

2.9.4 Trust and commitment

Many studies on industrial buying patterns emphasise the crucial role of trust and commitment in facilitating relationship performance. These two variables are very often studied together and there is considerable agreement about their combined action on organisational buying behaviour (Morgan and Hunt 1994). Based on Moorman *et al.* (1992), trust is regarded as the willingness to rely on an exchange partner in whom one has confidence. Anderson and Narus (1990) define trust as the firm's belief that another company will perform actions that will result in positive outcomes for the firm and not take unexpected actions that result in negative outcomes.

Ganesan (1994) posed two distinct components of trust; (1) credibility, which is based on the extent to which one partner believes that the other has the required expertise to perform the job effectively and reliably, and (2) benevolence, which is based on the extent to which one partner believes that the other has good intentions and motives beneficial to the first when new conditions arise, conditions for which a commitment was not made.

Morgan and Hunt (1994) argue that the presence of commitment and trust is central to the success of relationship marketing, not power and its ability to "condition others." They argue that commitment and trust are "key" because they encourage suppliers to; (1) work at preserving relationship investments by cooperating with exchange partners, (2) resist attractive short-term alternatives in favour of the expected long-term benefits of staying with existing partners, and (3) view potentially high-risk actions as being prudent because of the belief that their partners will not act opportunistically. Therefore, when both commitment and trust (not just one) are present, they produce outcomes that promote efficiency, productivity, and effectiveness. Commitment and trust lead directly to cooperative behaviour that is conducive to the success of a relationship.

Regarding commitment, the concept has been widely investigated in the literature, mostly by Relationship Marketing and International Marketing Purchasing (IMP) researchers. The diverse perspectives of the researches have led to a variety of definitions, hence creating confusion (Kim and Frazier, 1997). Derived from some of the most important researches carried out (Anderson and Weitz, 1992; Dwyer *et al.*, 1987; Moorman *et al.*, 1992; Morgan and Hunt, 1994), the concept can be defined as the willingness of a party to develop and maintain his relationship with another party. Commitment implies the importance of the relationship to the partners and desire to continue the relationship into the future. Thus, commitment assumes that the relationship will bring value or benefits to both parties. Because commitment may be motivated by different factors, hence there are different types of commitment (Meyer and Allen, 1991; Geyskens *et al.*, 1996). These include affective and calculative commitment. In affective commitment a partner would desire to continue a relationship because he likes the other partner and enjoys the relationship. In contrast, calculative commitment is the extent to which a partner perceives the need to maintain the relationship given the significant anticipated termination or switching costs of terminating a relationship. It is a result of calculation of costs and benefits, encompassing assessment of idiosyncratic investments and availability of alternatives (Geyskens *et al.*, 1996).

Geyskens *et al.* (1998) argue that the feelings of trust and commitment influence partners' behaviour, driving them to engage in long-term relationships. The main idea is that one partner's trust and commitment are closely linked to the regularity and the stability of his exchange. A confident partner would not have an incentive to switch to another partner, but will commit him/herself to maintain the relationship, thus, a stable relationship develops.

Commitment manifests itself not just in the investment adaptations the parties make to each other, but also in the perceptions each partner has about the other's degree of commitment to the future of the relationship. Ford (1980) argues that the development of a relationship is dependent on the perceptions of commitment held by each party. Commitment may be shown by investment of time or money in the relationship or it may just be a willingness by one partner to make changes and work towards mutual goals and benefits.

2.9.5 Trust, commitment, cooperation and satisfaction

The relationship between trust, commitment, cooperation and satisfaction has been described in different ways in the literature. Although the existence of a link between the four variables seems obvious in the vast majority of the studies, there is limited agreement about which variable is an antecedent or a consequence of the others. Several researchers have, however, established trust as an antecedent of commitment (Geyskens *et al.*, 1996; Morgan and Hunt, 1994; Dwyer, *et al.*, 1987). Most of them were based on the works of Dwyer *et al.* (1987) and Morgan and Hunt (1994). Theoretical and empirical researches have shown that if one party does not trust his partner, he will not commit himself to the relationship with the partner. In addition, the results of several other studies indicate that satisfaction is an antecedent of trust (Ganesan, 1994). Thus, a non-satisfied partner will not be able to feel confident in his partner, while others argue that trust is an antecedent of satisfaction.

Wilson (1995) presents thirteen variables that have theoretical and empirical support to buyer and seller relationships. These include; commitment, trust, cooperation, mutual goals, interdependence, performance, satisfaction, comparison level of the alternative, adaptation, non-retrievable investments, shared technology, summative construct, bonds (both structural and social bonds). This shows that commitment and trust are the most dependent variables used in buyer-seller relationships studies (Dwyer *et al.*, 1987; Moorman *et al.*, 1992)

It has been demonstrated that there is a link between cooperation and trust. Trust is an antecedent of cooperation in industrial relationships (Ring and Van de Ven, 1994). Morgan and Hunt (1994) give the details of the direct influence of trust and commitment on cooperation. They argue that to achieve cooperation, some degree of trust and commitment is essential. Kim and Mauborgne (1997) determined that fair process between exchange partners like the cane growers and the millers would help to bring about trust and commitment, which

in turn, maximise co-operation and business performance. In contrast, traditional tools of resource allocation, economic incentives and organisational structure tend to produce an attitude of outcome satisfaction, which will lead to compulsory co-operation, and a lower level of performance. The greater the levels of trust between exchange partners, the more likely the cooperation between exchange partners and cooperation itself breeds trust (Figure 2.1). Therefore, trust enables things to happen. As a bilateral investment in the relationship, cooperation seems to exist in most of the regular and stable relationships. After a period when satisfaction, trust and commitment have developed, the two parties begin to engage in activities such as co-development of products, co-investments, and technical advice. This cooperative behaviour reinforces the relationship, the stability and the regularity of purchases.

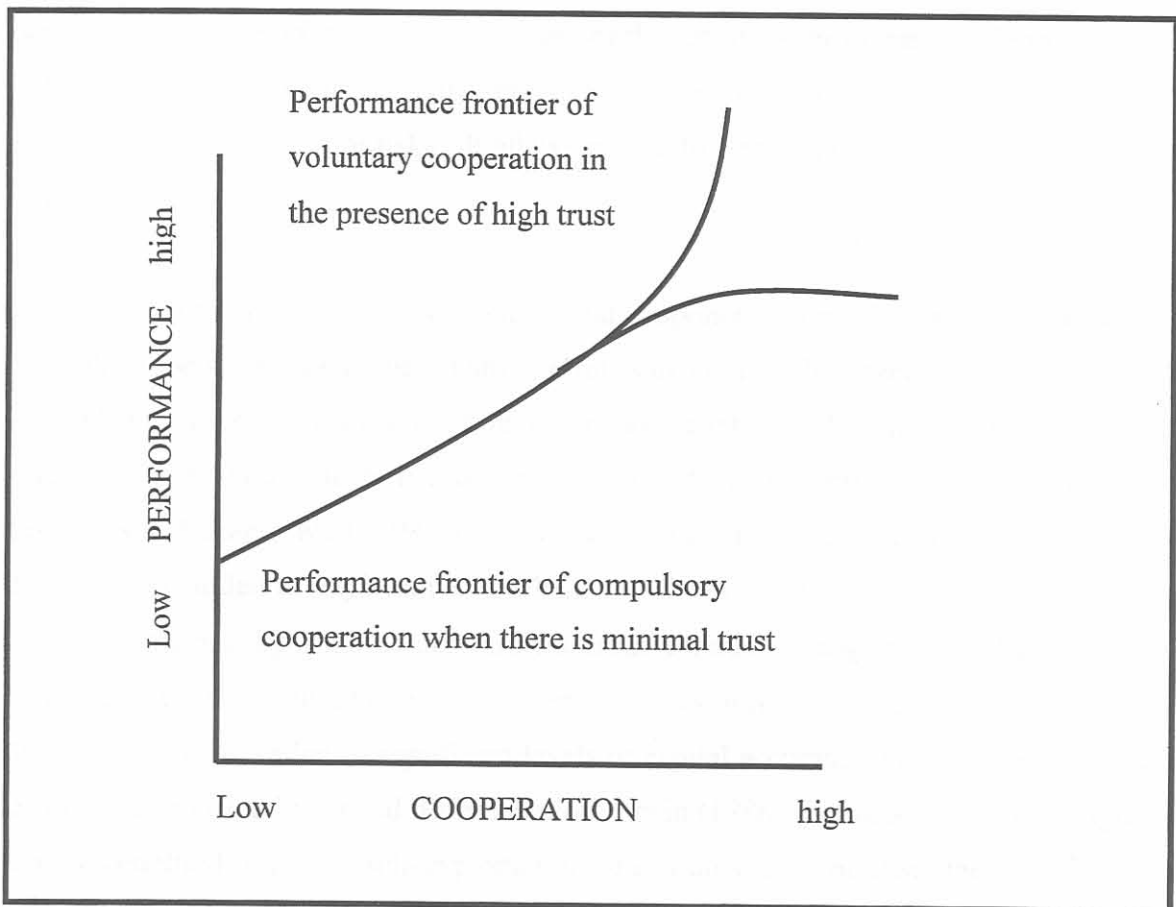


Figure 2.2: The effect of trust and cooperation on performance

Source: Kim and Mauborgne (1997)

2.10 EMPIRICAL STUDIES ON CONTRACTUAL RELATIONSHIPS IN AGRICULTURE

2.10.1 Economic benefits of contractual relationships

The economic assumption of contracting is that parties get more benefits from the contractual relationship compared to non-contracting parties. The best contractual outcome as put by Poirier and Reiter (1996) would be when both parties in the relationship experience a win-win situation. Contracts enable organisations to concentrate on their core competences and out-source all other production and service activities needed in the business. In a way contracts allow division of labour. A contract is a binding promise to deliver in the future to the other party a service or product against payment or other counter-performance. Hence, contract law is based on monetary terms. The contract therefore, is viewed as a tool that the contracting parties use to divide future risks. It allows parties to better anticipate future behaviour of the other party.

According to the neoclassical economists and proponents of agribusiness, a contract ensures mutualism between contracting parties (Binswanger and Rosenzweig, 1986). When freely entered into, a contract allows growers to make better use of their specific endowments in imperfect markets and to arrive at combinations of income, effort, and risk reflecting their resources and tastes (Watts, 1994). However, viewed from the dependency position, contract farming is regarded as exploitative (Dinham and Hines, 1983). This assertion overlooked the benefits obtained by smallholder farmers from contract arrangements. Buch-Hansen and Marcussen (1982) contradicting the dependency position, argue that out-grower schemes in Western Kenya have led to significant levels of capital accumulation, and benefiting sections of the peasantry lead to social differentiation. Levin (1988) concluded that, while agricultural capital benefited from the "self-exploitation" of peasants, in some cases the peasants have also benefited in that out-grower schemes have had differential effects on the peasantry. They provided the conditions for the reproduction of both a middle and rich peasantry.

Bucklin and Sengupta (1993) argue that there are many benefits from contractual relationships as there are the motives for entering into such relationships. However, understanding contractual relationship outcomes is critical because many contracts are said to have poor outcomes and are difficult to track quantitatively. Different scholars have

evaluated contractual relationship outcomes in different ways; for example, objective measures such as duration (Parkhe, 1998; Gulati, 1998), perceived effectiveness (Bucklin and Sengupta, 1993; Mohr and Speckman, 1994) and sales (Mohr and Speckman, 1994). Bucklin and Sengupta (1993) identified five factors affecting the effectiveness of contractual relationships. These include project management (power imbalance, managerial imbalance and conflict), project pay off, partner match (prior history, organization compatibility), age and rate of technological change.

Kliebenstein and Hillburn (1992) in a study of contracts in the poultry industry argue that the advantages and disadvantages of contracting are different for contractors and contractees just as their reasons for contracting. For the farmer the advantages include; reduced risk, reduced capital needs, improved technical support, more fully utilised labour and facilities, improved cash flow and the opportunity to produce a product. Contract farming provides an assured market for the grower, access to the company's services, and easy access to credit. Even if the company does not give loans, the contracts are generally accepted by banks as collateral (Levin, 1988). However, the disadvantages include; loss of managerial control, the need to work with contract management, and unguaranteed facility use. The advantages to the contracting firm include; reduced capital requirement, reduced coordination of production to match input supply, improved product uniformity, and a reduction or sharing of risks. The risk with respect to consistent supply and quality of inputs would be reduced. However, by offering a base payment in both good and bad years to the contractees, the contractor assumes the risk associated with a volatile pricing system of livestock in the open market (Zering and Beals, 1990).

A survey by Rhodes and Grimes (1992) indicated that contractees were asked for reasons that make contractors and contractees to enter into contracts. The two most popular answers, in 1990 were (1) lack of capital, and (2) contracting was less risky than independent production. In 1992 there were five top reasons and they were ranked a little different from those given in 1990, namely (1) contracting is less risky, (2) contracting provides more income or a better cash flow, (3) contracting is a way of getting started, (4) I like it, it is better for me, and (5) contracting simplifies management.

A closer look at the literature on contracts indicates that there is a consensus that contractual relationships improve the income stability of the farmers, facilitate risks sharing, ensure

technical support to the farmers, provide assurance of a market and provide access to credit (Rhodes and Grimes, 1992; Kliebenstein and Hillburn, 1992; Zering and Beals, 1989; Laura, 1994; Hillburn, 1993; Hennessy and Lawrence, 1999).

2.10.2 Smallholder farmers within a contractual relationship

Contractual relationships are a result of organisations reacting to the competitive business environment. These relationships require organisations to focus on developing their core competences in order to be competitive in the market. In line with this reasoning, organisations evaluate what is the firm's knowledge base and which functions produce the most value for the customer? What functions and processes can be out-sourced and which processes and know-how areas are strengthened and by what means? (Anderson *et al.*, 1994). Should the firm hire more experts or start a co-operational relationship? Firms bring their entire relationship network into the cooperation effort, as the individual firms do not operate by themselves, but they usually belong to several different networks of companies. Hakansson and Snehota (1995) define the relationship approach as an inter-company relationship development followed over time, rather than on single exchange episodes and transactions. Relationships are valuable resources, which provide considerable returns on the investment of time and money devoted to their development, though they do not appear on the balance sheet. Thus, relationships can be a source of value creation for stakeholders.

Literature describing business relationships has shown a glut of diverse attempts to characterise and describe the relationship concept as the relationship is examined from different perspectives (Hakansson and Snehota, 1995). This is a result of the variety of business environments from which these relationships originate, develop and break up. Therefore, depending on the business context, relationships have their own distinct personalities and no two relationships are alike. Such heterogeneity is a problem, though it can be positive for the relationship.

Advocates of contractual farming promote it as a dynamic partnership between trans-national corporations and small farmers that benefits both, without sacrificing the rights of any of them. It is offered as a vehicle for the transfer of technology, the modernization of smallholders, and the creation of a stable and politically conservative class of family farmers. The increase in incomes and use of modern technology by peasant farmers is regarded as

evidence of the unambiguous benefits of contract farming to all concerned (Clapp, 1994). Contract farming, however, is criticised in that it would lead to disruption of subsistence production and inevitably impoverishment of the rural poor, and it is seen as the latest instrument for the subordination of the smallholders, creation of a class of virtual "development peons". Clapp (1994) notes that writers in the dependency tradition focus on the company's role as the sole purchaser of the farmer's produce and sole supplier of the essential inputs and credit. Hence, this raises the issue of domination and subordination, an issue that advocates of contract farming tend to ignore.

Glover (1987) in a study on contract farming argues that contract farming can present a variety of problems for the smallholder out-grower farmers. Many of these problems could be a result of difficulty in coordinating the production and deliveries in a manner that ensures optimal flow of raw material to the processing firm. Glover (1987) suggests three main sources of difficulty in coordination; (1) failure of growers to comply with company instructions, (2) the company's lack of physical or managerial capacity, and (3) exogenous variables like weather, and competition for a company-owned machinery during harvesting periods.

Woods (1999) points out that the main issues of concern in supply chain management include: sharing of long-term development goals and seasonal business planning; the relationships between operational staff within the businesses on issues such as timing, amount, ripeness and temperature of deliveries; the development of shared quality and safety standards and how they will be measured and monitored; the information systems to track product and standards. At the farmer level, Woods (ibid.) argues that technical and professional issues required to support a supply chain may include: (1) facilitating the development of relationships between farmers to allow their participation; (2) the development of relationships between members of the supply chain; (3) information flows between members of the supply chain; and (4) establishing common standards between members of the supply chain and optimising performance within each level of the supply chain, as well as in the linkage processes. She points out that, in most cases, farmers avoid to be members of a supply chain because they fear to lose independency, possible break-up of an existing relationships and the culture of being used to spot market transactions. The spot market transaction is based on the idea of increasing the existing pie, while the supply chain culture is based on sharing the benefits of the pie.

Woods (1999) in a study of the horticulture supply chain in Australia found that Australian horticultural producers who established relationships with either a domestic or an export supply chain can be provided with a plan of quantity, a timing of supply, and have agreed pricing arrangements. Woods argues that a relationship ensures immediate feedback on holding quality and presentation. Retailers in the horticulture industry depend on their suppliers in a similar way as the suppliers depend on the retailers. This suggests that there is mutual dependence and cooperation between the parties. This is evidenced through price negotiations. Such negotiations recognize the value of each partner and the need to invest in an ongoing loyalty to the relationship and ensure that all players in the chain have an incentive to continue to operate. Hence, "closer relationships also provide opportunities for farmers to extend their operations along the supply chain. For example, additional grading which improves product shelf life and reduces wastage represents extra value added by the farmer and can be recognized with high payment by retailers" (Woods, 1999: 4)

2.10.3 Trust and supply chain performance

Several empirical studies, which acknowledge the contribution of the New Institutional Economics (NIE) to supply chain relations, suggest that the main factors influencing efficiency in a supply chain include informal elements, which comprise of trust, norms or standards that support exchange relations irrespective of contractual obligations and authority relations, which are exerted throughout the supply chain by those who have superior power in relation to the market or information (Cullen and Hickman, 2001).

Milford (2002) in a study of the state of the value chain in the Australian Sugar Industry, found that millers perceive the level of trust between millers and growers to be better than the perceptions of growers and harvesters. Milford attributed the perception of lack of trust by growers and harvesters to the poor performance of the industry in the past, individualism on growers' part and perceived power and information imbalances.

A study by Medina-Munoz and Medina-Munoz (2002) on the role of trust in inter-organisational relationships' control and success found that all the different types of trust used in the analysis were positive and significantly associated with the success of the relationship

between tour operators and accommodation companies. This suggests that trust is associated with the success of the relationship.

Tregurtha and Vink (1999), in a study of trust and supply chain relationships using a case study of the South African Breweries (SAB) and the Taung barley project, found that the efficiency of barley production in Taung determines whether the trust relationship between the farmers and SAB will continue. They argue that trust cannot make an economically bad relationship good, but all it can do is make a good relationship better. The SAB emphasised that sound economic principles determine the long-term future of their involvement with the farmers. Similarly, the small-scale farmers who are involved in this supply chain indicated that they would only continue to produce barley as long as it represented the most profitable allocation of their resources, subject to their low risk preference. They pointed out that the trust alliance they have with SAB raises their net profit margin because it reduces their transaction costs. However, the scope for cost reduction is limited and cannot compensate for inefficient resource use. These findings imply that trust is a result of the benefits the individuals realise in the relationship. However, the study was qualitative in nature, hence it lacked the quantitative importance of trust in the relationship.

Morgan and Hunt (1994) argue that trust and commitment are very important factors if a company is going to succeed with its relationship marketing. They conclude that trust is positively affected by shared values and communication among supply chain partners, but negatively affected by the presence of opportunistic behaviour. They viewed shared values as the extent to which the trusting parties' goals, behaviour and way of work are congruent. In their view, communication is the extent to which information is shared between the parties, whereas opportunistic behaviour refers to the degree at which parties seek individual gain. Morgan and Hunt's results correspond to their model. They found that the presence of trust in a relationship has a positive effect on commitment, cooperation, and functional conflict, and a negative effect on uncertainty. Considering Morgan and Hunt's findings, it is clear that they were dealing with relational trust as opposed to the other types of trust.

A study by Moore (1998) aimed at understanding the importance of relations within logistic alliances also studied the concept of trust in relationships. Though the study was not exclusively about trust, it also focused on factors affecting the development of buyers' trust and relationship commitment in logistic alliances (Moore, 1998). The study assumed that

equity is important for the development of trust, where equity implies the sharing of benefits and burdens. This assumption that equity is an important factor for the creation of trust was supported by Moore's empirical findings.

Doney and Cannon (1997) examined how trust emerges and the impact of trust on buying behaviour in business-to-business relationships. Two kinds of trust were studied and they involved trust between the customer and the selling company as a whole and trust between the customer and front-line employees of the selling company. Doney and Cannon assumed that customers that trust companies as a whole are dependent on calculus factors, such as the selling company's image and size. The logic to trust front-line personnel is different for different customers. Therefore, trust in this context depends on emotional factors such as social contact, similarity between parties and mutual affections, but also on harder factors like power and expertise.

Scholars in chain relationships increasingly acknowledge the role of interpersonal factors such as trust on inter-firm outcomes. Larson (1992), studying the governance of exchange relationships, found that personal relationships and reputations, coupled with knowledge of the firm's skills and capabilities, shape the context of new exchanges between firms by reducing risks and uncertainties about the motives and intentions of the other firm. Several studies suggest that interpersonal trust operates in an independent, yet complementary manner to many organisational variables (Andaleeb, 1992; Anderson and Narus, 1990). For example, it facilitates relational processes, such as collaboration and relational norms, but has limited impact on performance (Jap, 1999; Moorman, Zaltman and Deshpande, 1992). However, empirical results suggest that interpersonal trust is capable of safeguarding joint competitive advantages against varying levels of ex-post opportunism. Thus, adverse effects of opportunism suspicions may be limited to less tangible relational outcomes, such as expectations of continuity and evaluations of an exchange counterpart.

2.11 FACTORS AFFECTING SUPPLY CHAIN PERFORMANCE

A firm's competitive advantage no longer depends on its own internal capabilities but on the links it forges with external organisations (Lewis, 1995). Inter-firm relationship performance is complex, multidimensional, and includes affective, behavioural, and economic aspects

(Johnson and Raven, 1996). Relationship performance describes the perceived contribution of the relationship to the members of the supply chain compared to what they could realise outside the relationship (Sollner, 1999). A relationship's positive performance is what makes the partner firm to stay in the relationship because it wants to as opposed to being pressured by external forces. Sollner argues that although Williamson (1985) emphasises efficiency or economising transactions as performance measures in exchange relationships, such an approach cannot satisfactorily explain the existence of different organisational arrangements. This is because firms enter into close business relationships for a variety of reasons. Moreover, measuring performance for privately owned firms in a supply chain is often problematic due to the unavailability of performance data to the public. As a result, subjective measures are often used in measuring relationship performance (ibid.).

There exist two schools of thought about the success of a relationship. The first school of thought advances that the concept of success is associated with the general satisfaction of participants within the inter-organisational relationship (Anderson and Narus, 1990). Satisfaction is defined as a positive emotional state resulting from the assessment of all the aspects of a well functioning relationship maintained by one organization with another. The concept of satisfaction is based on the premise that success is determined by a partner's positive experience of the other partner's ability to meet the norms and expectations of performance (ibid.).

The second school of thought advanced by Johnson and Lawrence (1988) refers to success in inter-organisational relationships as a quantitative measure of mutual benefit obtained by organisations participating in the relationship. Organisations use measurements of financial results, such as profits, or market share, inventory and reduction of costs (Beamon, 1999). However, Beamon argues that such measurements may not be adequate for the analysis of the entire supply chain. Anderson and Narus (1990) considered that many relationships might require a long time before the results can be measured. They argue that success refers to the overall assessment of an inter-organisational relationship by the associated organisations. Therefore, success is nothing else but the generation of satisfaction for the organisations participating in the relationship, resulting from the fulfilment of the expectations of performance. Thus, this study uses satisfaction as a measure of performance. Satisfaction is a close proxy for perceived effectiveness and has a potential to predict future actions of chain participants.

Varadarajan and Cunningham (1995) have called for a systematic analysis of the factors associated with inter-firm benefits. A holistic, perceptual approach to measuring relationship performance as the primary firm benefit in the negotiation context is desirable because it is flexible to capture the diverse and idiosyncratic evaluation criteria of the firms negotiating alliances (Yan and Gray, 1994). It is believed that in addition to standard objective performance measures such as financial returns, interests of the partners extend to matters such as reputation enhancement/protection, relationship maintenance and precedent-setting (Lax and Sebenius, 1986; Savage *et al.*, 1989). It should be noted, therefore, that perceptual performance measures have shown to correlate well with more objective criteria such as financial performance (Geringer and Hebert, 1989). The concern over appropriate evaluation criteria has been shown to be particularly important for relationships utilising diverse control mechanisms such as authority and trust.

Ittner and Larcker (1997) in their study on quality strategy, strategic control systems, and organisational performance, describe their exploratory analysis of the impact of a number of process-management techniques, including some supply chain practises, on overall firm profitability. The supply-chain management practices these authors examine are the extent of supplier or customer involvement in product design, the importance of non-price factors in partner selection, and the establishment of long term partnerships with suppliers and customers. They found that establishing long-term partnerships with suppliers and customers improves profitability. They argue that the most important factor in measuring performance is the understanding of the role of formal versus informal control mechanisms in implementing and monitoring strategic plans. Their study shows that several strategic control practises are negatively associated with performance, which they argue is consistent with claims that formal strategic control systems can actually hinder performance in some circumstances by focusing attention on formal and rigid action plans, targets, and information gathering when flexible and creative strategic responses may be more appropriate.

Forker (1996) studied factors affecting the supplier quality performance and found that when transaction-specific-investments are considered in the performance analysis, supplier's economic dependence on the customer was negatively correlated to the quality of the components produced and supplied. He argues that such findings support the theory of transaction costs, which predicts that asset specificity increases transaction costs regardless of governance type. Forker further argues that although the results did not support TCE's

assertion that bilateral dependence will result in market failure, because the customer's economic dependence on its suppliers was not significantly related to component quality performance. However, since market failure is embodied in suboptimal performance by either the buyer or the supplier on any of the dimensions in which they evaluate their exchange relationship, the negative correlation of the supplier's dependence to performance supports TCE theory.

Ramdas and Spekman (2000) used six variables that reflect different approaches to measuring supply chain performance. These included inventory, time, order fulfilment, quality, customer focus, and customer satisfaction. Their results indicate that authority balance is positively related to alliance performance. The more one partner controls the alliance through authority advantage, the greater the likelihood that the alliance would perform poorly. The interaction between trust and authority shows that the existence of trust affects the relationship between authority balance and performance. In the case of the relationship between authority balance and performance, it is shown that trust dampens the positive relationship. Trust and authority balance serve somewhat as proxies for each other in the prediction of relationship performance. Where a firm can trust its partner, the balancing of authority is not as critical for enhancing performance. Teegen and Doh (2002), concurring with Ramdas and Spekman (2000), conclude that trusting relationships are perceived to promote alliance performance and that the presence of authority advantage has a negative effect on alliance performance, which is further worsened by the absence of trust.

Paulin *et al.* (2002), studying relationship strength and the performance of business-to-business partnerships in emerging biotechnology clusters, conclude that the performance of partnerships in biotechnology clusters depended on how strong the parties see their relationship. They argue that: long lasting exchanges, with perceptions that partners are able to adapt to changing circumstances, might lead to formal or informal agreements to solve their problems, to the satisfaction of both parties (flexibility); the degree of mutual trust, commitment and benefits reflected through cooperative relationships in which each party would not act opportunistically, as a result of strong bargaining position (solidarity), play an important role in the performance of the relationship. Partnerships in biotechnology were more dependent on the perception of effective communication and fairness. Communication refers to the accuracy and timeliness of information provided by business partners and availability of the partner as well as the degree to which the partner offers open access to

additional contacts in the network. Fairness is the fair behaviour of the partner as well as the willingness of the partner to distribute benefits and costs between the parties in a fair manner and the adherence of the partner to business norms or principles of the industry.

Gassenheimer *et al.* (1996), in their study of cooperative arrangements among entrepreneurs, found that the age of the franchise relationship has a negative relationship to the performance of the franchise. They argue that as the relationship gets older the franchisee becomes complacent, and hence has a poor performance. Relatedly, studies have shown that the duration of a relational exchange is related to the level of trust between parties. Sohn (1994), in a study of social knowledge as a control mechanism in Japanese FDI behaviour, found that in-depth social and cultural knowledge facilitates coordination of transactions by making potential partners' behaviour both understandable and predictable. He argues that as social knowledge of transactors increase, information asymmetries decrease, thereby increasing trust as a result of low information asymmetries and uncertainty.

It is commonly recognised that suppliers who become dependent on their buyers often face performance problems resulting from opportunistic behaviour by the partners or from lack of information (Swaminathan *et al.*, 2002). Williamson (1993) argues that firms in a long-term relationship can face a hold-up problem in partner behaviour if they do not have alternative partners. Singh and Mitchell (1996) found that firms commonly face adaptation difficulties in times of environmental change if they become too reliant on partners, while Uzzi (1996) found that if a firm becomes over embedded in a network, the lack of arms-length relationships tend to isolate the firm from the market's imperatives and increase its likelihood of failure. Therefore, it is important that there is a mutual relationship, since a relationship that is one-sided would result in poor performance because of opportunism and hold-up syndrome between the parties.

2.12 SUMMARY

Contract law has been shifting from classical contracting through neoclassical contracting to relational contracting. Relational contracting is extensively operational in the business context of long-term relationships. Williamson (1985) explained the interdependence of contracting and governance with bilateral governance being appropriate to long-term

contractual issues. Ring and Van de Ven (1994) quoted Atiyah (1979) that a paradigm shift prevails in contract law from single and discrete transactions towards more accommodating future risks by relationship management processes, instead of adhering strictly to the written contract and its wordings. They further argue that overtime the development of the formal and informal processes of negotiation, commitment and execution complements the formal contractual relationship. The increase in the elements of personal relationships and the longer the cooperation, the more clearly the formal agreements mirror informal understandings and commitments. They emphasise that social-psychological processes take longer to develop than formal contracting itself. Hence, contract negotiating, drafting and writing processes may take longer, but the psychological aspects of the partners mentally adapting during the cooperation will take more time.

This chapter provided the review of literature related to the development and motivation of contractual relationships. The basis of contractual relationships as encompassing transaction cost economics, resource dependence, agency costs and relational theories were also discussed. Transaction cost economics is concerned with minimisation of costs of exchange. It focuses on the ex-ante and ex-post costs. Transaction cost theory argues that minimising transaction costs is the primary motivation for adopting alternative organisational designs like relational exchange, whilst resource dependence argues that firms cannot develop and compete effectively without relying on other firms for resources that may not be internally available. The agency theory on the other hand focuses on the difficulty of aligning the goals of the principal and the agent in a contract, which tend to result in moral hazard and adverse selection problems. The limitations of each theory in effectively addressing the existence of contractual relationships result in the emergence of the relational theory. The relational theory, in addition to recognising the transaction cost minimisation, also incorporate social capital, such as trust and commitment as important elements that explain long-term contractual relationships.

Relational exchanges are only one relatively new type of vertical coordination, and as such researchers who focus on contracting or vertical integration generally overlook them. Hence, most research loosely applies findings from integration and contracting problems to all forms of vertical coordination. Because relational exchanges are a blend between firms interacting within a traditional open market setting and a vertically integrated system, no single theory completely explains their existence. Instead, all four approaches to explaining vertical

coordination can be used in building a conceptual framework for understanding why relational exchanges are formed and the results of alternative design choices.

The literature has shown that vertical coordination through contractual arrangements has been practised in agriculture. However, most studies have been concentrating on the efficiency of the contracts and none of these studies have looked into the quality of the contractual relationship of the farmers and the processing firms, hence this study is designed to address this gap.

The issue of governance structures in agricultural supply chains has attracted many scholars. The reviewed literature presents agricultural supply chains as both demand and supply driven and as such argues that the governance structures in these supply chains become important in order to understand the use of power and authority within the chain. The literature has shown that the type of governance structure determines the flow of information and material within the members of the chain and it has a direct impact on the performance of the supply chain. It has also shown that social capital such as trust, commitment and cooperation enhance the performance of exchange relationships.

Evidence from previous studies discussed in this chapter suggests that there are gaps between the perceptions of suppliers and buyers regarding the nature of their exchange relationships. Specifically, it has been suggested that the perceptions of each partner in a relationship are a result of accumulated interaction between the two parties. However, a key factor in the ability of the parties to be able to adapt and actually benefit from the relationship is knowledge of the perceptions of the other partner regarding their relationship.

This research continues the search for information on contractual relationships in the agricultural supply chains, and most importantly it empirically analyses the quality and the role of social factors, such as trust, in the performance agricultural supply chains. The next chapter will provide the theoretical and conceptual framework followed in this study.