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Reflections on Relational Contracts

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1. if there's never going to be a temptation to defect, it's not a relational contract

I'm not convinced, for example, that Amazon's customers have a relational contract with Amazon. Do they make an "implicit promise" promise to Amazon? I don't think so. If they want to buy something somewhere else, they simply do so.

Some cases are tougher, of course. For example, one might think that Southwest airlines might not need to offer a relational contract (hereafter "RC") to its baggage handlers. Surely it's much more interesting to be a baggage handler at SW than at any other airline? So perhaps Southwest doesn't need to make an implicit promise to get baggage handlers to be "part of the team", to "do what it takes"? Perhaps, but perhaps not – it might be the case for example, that without an RC, Southwest could abuse such an expectation – forcing baggage handlers to work very long hours, or to do dirty or dangerous work...

Which is all by way of saying that for me there's one simple test of whether an RC is in place. If I know that the party with whom I might have an RC is going to disappear tomorrow, and if the knowledge doesn't change my behavior – then I certainly don't have an RC with them. Thus "we will give you a great product" is probably not an RC, because if they aren't great products the customer simply won't buy them, "we'll go the extra mile when you are dissatisfied" might be?

2. But it might well be a relational contract even if there's not a temptation to defect *right now*

On the other hand, there may well be a relational contract in place even if there doesn't seem to be any immediate threat of defection. Both papers on Toyota, for example, pointed out that Toyota's relational contracts seem fairly stable – that it would be foolish for either Toyota or for its suppliers or employees to break them. To my mind stability is a sign of well working relational contracts. As a manager, an ideal might be to build RCs that are stable in exactly this kind of way – where everyone can see that the benefits for all parties far outweigh any benefits of "defecting".

3. Firms often (usually?) have multiple relational contracts

Nearly every paper made this point well. Nearly every firm discussed has relational contracts not only with its employees with also with its suppliers, and often with its complementors and its customers. The team writing about Intel, for example, included a particularly nice discussion of Intel's RC with complementors elsewhere in the value chain, and the pressure that was put on the RC when Intel moved into the motherboard. One of the papers about Google described no less than five RCs with Google employees alone! (One interesting question, of course, is whether these contacts are separable – could Google break one – eg "your work will change the world" – without impacting the others?)

4. Some relational contracts operate in two directions, while some do not

Most papers suggested that when a firm offers an RC to its suppliers, the suppliers nearly always offer an RC in return, but that this need not be the case with eg employees or customers. In the case of employees, I might promise to treat you well and keep you on the balance sheet as long as you behavior

in a particular way – but you may not need to make a promise to the firm in return – you might just show up and “do your job”. Again, the key question here is whether you are making a “promise” to the firm that you might be tempted to break. If not, you haven’t offered them an RC.

5. Relational contracts can be (usually are?) unbalanced?

Consider the case of Toyota’s relationship with its suppliers. Toyota’s temptation to defect – and the punishment if they do – may well be “larger” than those faced by its suppliers. Different suppliers may have different temptations to defect, and fear different punishments if they do.

6. Can you have a relational contract with your customer?

It seems to me that the answer to this is clearly “it depends”. Sometimes, it’s very clear that firms have RCs with their customers. The McKinsey team suggested, for example, that McKinsey has a very clear RC with its customers: namely that they will tell them if they think a particular project is not well specified or not worth doing. Notice that there will be clear temptations to defect from this “but it’s such a big study... and we’re low on work right now...” – so that the both the benefits of “cooperation” will have to be clearly communicated throughout the firm “we’re not the kind of firm that takes on make work kinds of projects...” as will the potential punishments “they will push you hard to take this kind of study, but if you do, it really comes around to bite you, let me tell you about the time we... and about the effects on our other relationships...”

Other clear examples when firms often have RCs with their customers are when there is a real (or perceived) threat of “lock in”. Here firms try very hard to persuade their customers they will not defect – jack up prices, cease introducing new products etc – in order to persuade them to buy.

But some cases are less clear cut. Are brands RCs? Nearly all the Starbucks and Whole Foods teams made strong cases that they might be. It’s clear that all brands carry an implicit promise, so in that sense one might think of them as RCs. But I think it may be dangerous to carry this too far. Again, my test would be the degree to which the customer’s purchase was driven by a “shadow of the future” or by expectations about the behavior of the firm over time. Google clearly has an RC with its customers, by which it “promises” not to abuse the data it collects about them. But does Coca Cola have an RC with its customers? Probably not – if a particularly can of Coke doesn’t give me a great feeling of refreshment, do I feel betrayed? Perhaps, but I’m not sure it’s useful to think of this in terms of an RC. In the case of Starbucks and Whole Foods, to the degree that the purchase decision is driven by something that cannot be observed at the time of purchase – that the product is produced organically, for example, or that the company is not “abusing” its supply chain, or that the firm will continue to run coffee shops as “neighborhood stores” one might usefully think of this as an RC. But I don’t think the quality of the coffee is the subject of an RC...

7. Can end consumers have an RC with the firm they buy from?

Some of the Apple teams clearly think that you can, and that Apple customers “promise” to promote the brand to their friends and to buy products in the future. But would Apple ever “punish” them if they failed to do this? I’ll confess that I’m not convinced.

Of course customers can certainly have RCs with their “suppliers” so there’s clearly a spectrum of possibilities here.

8. The “Social contract”

Several teams observed that there were RCs in place that appeared to be functions of the institutional or social environment in which the firm was embedded, in addition to – or in place of – any firm specific RCs. This seems to me exactly right. You could, for example, choose not to tip in a restaurant, or to habitually lie to strangers who ask you for directions on the street rather than to go out of your way to help them. But by and large you don’t lie, cheat or steal. As I said in class, the sociologists discovered relational contracts a long time before the economists did.

9. Embedding RCs in practice

There were great hints in several papers as to how RCs come to become embedded in routine practices and ways of behaving within firms. Several papers talked about the hiring practices at Google, Goldman Sachs and McKinsey in these terms, for example. A delightful discussion of Wells Fargo’s practices (whose admonition to its employees – “run it like you own it” is only rivaled by Nordstrom’s “use your good judgment in all situations” as the summary of an RC) was particularly enlightening in this respect. The team discussing Porsche talked not only about how the firm’s strategic positioning (we only make sports cars) reinforces its RC, but also about how the CEO’s decision to “stake his own personal wealth” at a time of financial stress had the effect of dramatically strengthening the firm’s RCs going forwards.

10. The Evolution of RCs over time

Here a number of papers raised fascinating questions.

- Is it always the case, for example, that RCs get more stable over time?
- What happens to firms that have extended very generous RCs to their employees – think of the perks at Google for example – when the firm falls on hard times?
- To what degree are RCs at small, high growing firms sustained by generous allocations of equity and a rising stock price? Did MS every have an RC with its employees? Will Google, once growth fades and the firm gets too big for equity to reflect any reasonable measure of individual performance?

These are exactly the kinds of questions we will be looking at over the remainder of the semester...