

Relational contracts: advantages and disadvantages



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Relational contract is defined as “ Contracts in which what is expected by both sides is not written out in detail but develops as an ongoing relationship.” (Chrystal: 1997 p. 702) whereas referring to CRC CI (2002), it deals with identifying and endeavouring an approach of mutual benefits through developing cooperative relationships and establishing a mechanism of risk-sharing. Thus, it is not only based on expectation but also underpins the mechanism of encouraging mutual collaboration between parties.

As per Kumar N (1996), relationships must have a degree of elasticity to flourish which cannot be established by enforcing legal force of contracts rather by mutual obligatory force of trust. (p. 105) and as the term ‘ relational’ refers to the expectancy situation that benefits both parties from its continuance therefore, establishing the element of trust between the parties leads to economical benefits of sustainable lower cost of performing business activities and strategic advantage of meeting organisational goals. As relational contracts rely on existence of corresponding expertise and knowledge that the parties don’t need to produce or buy in order to carry out transactions therefore, it cuts down short-run transactional (informational) costs, preventing parties to spend on buying expertise and information that other party can bring. The association between the parties also encourages innovation outcomes by sharing of information and skills so this people-orientated approach leads to develop competitive advantage which in turn manages the costs effectively. Thus, saving contractual cost that would otherwise have incurred in buying information as in classical contracts where there is not a free flow of data.

Nowadays, more concern is paid to manage relationships than to maintain contractual terms as Neoclassical and arm's-length contractual relations are against "lean" working which ensures mistrust and defensive behaviour that adds to transaction costs therefore establishment of partnerships especially between public agencies and services requires maintenance of trust. '

Adverse approaches to contracting in construction industry have led to reduced efficient industry with lower productivity levels however, the relational contracting approach has evidently increased the efficiency by developing partnering agreements and joint team goals and reviews that enhanced financial returns and reduced incidents and conflicts'. (Latham, 1994; Egan, 1998; RCF, 1995, ECI, 1997; CIB, 1997) It also supports creation of networks and also enhances goodwill that can be beneficial at the time when one company fails to work in the required way which saves cost of switching between the companies.

Relational contracts occur in variety of play between senior and middle-level managers, administration and employees, suppliers and the company so the strength of the relationship develops through the course of dependent learning that is hard to imitate. For example, according to Chrystal. K (1997: 72), the job specifications evolve over time which may not be same as when the person applied for the job. Also, there may be many problems in completely specifying the performance required by the other party. In other words, employee and employer have reciprocal obligations which the either party obliges to fulfil anyway even if they were imprecise or ill-defined earlier. If not, then the negative consequences may be evident. Therefore, having a more open-handed, relational contract approach in firms can avoid

the unconstructive circumstances, allowing employer to later specify the task and exploit the skills which also save cost that can be claimed by employee for breaching of the specifications in the formal contract. (Shore and Barksdale, 1998) however, parties may not disclose all the relevant information and interpret the terms in contract their own way which may give rise to adverse selection and moral hazard problems. This shows that presence of clauses may prevent the opportunistic approach and ensures reliability which signifies that 'real trust' does not exist in business world. (Williamson, O. E, 1993: 97-107) Also, if contractual relations are based on social norms then fewer transactional relations will be observed with primitive approach as most of them will exist between the reliable known parties whereas the legal approach proposes agreements with anonymous too. Thus, reducing the cost by specification of risk allocation if transactional cost were nil, decreasing coordination and informational expenses. Also it prevents ex ante opportunistic approach by establishing legal enforcement and reduces ex post opportunism by specifying rules. Thus, formal contracts are 'lubricant of economy'. (Schafer. H & Ott. C: 2004: 277-278) however, its clear specification to avoid opportunism can make contracts costly. Also Nooteboom (2002) criticises this view as contracts can be based on moral values, habits and certain other factors that ensure reliable performance as in relational contracts. Moreover, empirical research by Macaulay (1963) and Beale & Dugdale (1975) concludes that "Businessmen prefer relying on a man's word' in a brief letter, a handshake, or 'usual honesty and decency' even though there is high risk transactional cost included".

The underlying basis for formation of relational contracts is the value that it establishes over the years to maintain contracting relationships rather than investing sole concentration on transaction taking place between firms.

Different deferred remunerations like promotion based on seniority, lifetime employment, generous pension schemes all serve to the aim of establishing relational contract which develops long-term bonding. Thus, saving cost on investment in establishing future relationship. Also it can establish successful long-term bonding at the start of the relationship which saves costs by enhancing the probability ratio of establishing mutual policy objectives which can encourage alliance over the utilisation of resources that are scarcely available within the parties. (Brown et al., 2004, p. 748) This relationship flourishes over time that promotes flexibility of adapting to altering situations and priorities without affecting focus on outcomes thus leading to successful transactions between companies and saving cost that would otherwise have incurred in bringing the change. (Gibbons as cited from Klein's studies: 2005, p. 209) (Levin, 2003, p. 837) Also contracts that are established on relational basis rely on long-term reputation factor rather than contractual time-limit. (Kragly J et al: 2007) it is also backed by Williamson (2006), that ' parties don't renegotiate the terms in contracts as they carry symmetric knowledge in relational contracting however black and white contract involves costs that increases with the increase in number of terms in agreement' (p. 290). Referring to Gibbons (2005: p. 237), relational contracts can remedy the imperfection of the formal contract. Thus, saving cost on written agreement. Also relational contracts overcome the hardships of formal contracts that are enforced by law as formal contractual terms need to be specified before ex ante that the third party verifies ex post but in <https://assignbuster.com/relational-contracts-advantages-and-disadvantages/>

relational contracts, only contracting parties can notice outcomes ex post. Also the specification of ex ante can be costly so it is avoided in relational contracting. Thus, this 'self-enforcing' nature of relational contract saves contractual costs, allowing parties to utilise their elaborated knowledge and adapt to upcoming information as in employee-employer relationship. However, the same reason could lead to a disadvantage of not being enforced by a third party as traders might face a problem with ruling out of third party enforcement as they are most concerned about the identity of trading partners. (Brown et al., 2004, p. 748) and as per Levin (2003), relational contracts are based on 'self-enforcing' characteristic therefore, renegeing can not only end relationship but also can make other party suffer loss which in turn increases cost. (p. 836) however, the basis of establishing relational contract is the incentive that both parties share thus, halting the renegeing approach. Also the violator would suffer loss of reputation which delineates the 'self-enforcing' nature of relational contracting. (Klein & Nevin, 1997, p. 417)

The point of concern is stated by Simon (1995), that the capability of processing information by humans is limited (Bounded rationality) which can increase relational contract costs. Also contractual rawness can be a result of ambiguity aversion which can be haggling cost because of different acknowledgements of both the parties thus increasing the cost of transaction and contract contingency. (Williamson, 1985, Mookerji, 1998) however, in relational contracts the strength of the relationship develops through the course of dependent learning that is hard to imitate and is more flexible than classical contracts which require more cost of abiding by contractual terms

and as the relationship between trust and cost works inversely, the absence of trust would require compliancy to certain standards and rules so as to maintain relationship which then would increase the cost of setting conditions, negotiating, regulating and monitoring formal contracts. Thus, in medium to long term, relational contracting saves costs of uncertainty by establishing reliability on trust that lowers down the degree of insecurity on accomplishing objectives as trust decreases ratio of conflicts and opportunistic conduct. Also less control of regulation means the requirement of tight control is not necessary thus saving cost.

In conclusion, relational contracts approach within firms is very effective and need to develop trust across different cultures is required however, some multi-organisations with complex business dealings require formal contractual enforcements that are more cost-efficient for them whereas in construction industry, this is the most widely practised effectual form of contracting. Thus, relational contracts save cost by establishing mutual trust and encouraging multi-disciplinary approach which creates long-term tangible and intangible value that promotes mutual cost-efficient collaboration and flexible dealings however, on the other hand its non-specification can give rise to moral hazard and opportunistic behaviour problems which can further increase the cost. It is suggested that a win-win situation should be created that is founded on relational contracting to establish sustainable long-term relationships and trust which will keep the costs low as compared to formal contract enforcement.

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