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Strategic Alliances in Inter-firm Networks: A Framework for Building Trust and Effective Governance

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ABSTRACT:*The current trend of networking among firms is driven by a need for independent institutions to pool their individual areas of specialization skills, knowledge, and resource capabilities in order to develop innovative products that rival competitors, while mitigating risks and uncertainties in dynamic turbulent environments. However, the practiceof inter-firm networking logically raises the question on how to regulate the behaviors of actors with different motives, particularly actors who merely claim to be trustworthy, entering the network. The author explores this question by adopting a conceptual framework comprised of four main components: conditions influencing the choice of governance structures; reciprocity of trust; the cost of losing trust; and the embeddedness of economic transactions. In this paper, the author argues that the conventional view of governance structure must be extended and that trust, as one of three fundamental bases of governance forms, when applied as differentiated trust, can be an effective governance mechanism for managing inter-firm networks. The paper concludes that the importance of trust in economic activity warrants that firms and their partners build upon differentiated trust to improve the efficiency and effectiveness of economic as well as non-economic activities.*

KEYWORD: *Differentiated Trust, Inter-Firm Networking, Transactional Cost, Governance Structures*

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I. INTRODUCTION

It is widely acknowledged that innovation is fundamental to firm performance and economic success. The emergence of successful innovation is often the product of knowledge sharing and networking among different actors across the innovation and entrepreneurial spectrum. These exchanges and actions, both within and between discrete units, help to form evolutionary networking firms that pool their areas of specialization and knowledge in a way that harnesses the benefits of coordinated exchange. The literature is replete with studies (Balliet and Van Lange, 2013; Casciaro, 2003; Das and Teng, 1998; Puranam and Vanneste, 2009) that examine the determinants of governance structures among firms that network. At the same time, the boundary of the firm is continuously shifting, in terms of exchange relations, both within and between economic units that are legally and contractually independent. Theories of trust, agency, andtransaction cost have been drawn upon by researchers and practictioners (Gulati, 1995; Macaulay, 1963; Williamson, 1975, 1996) to arrive at an optimal governance structure for managing these relationships.

Trust-based governance mechanisms create a mutual confidence that no party to an exchange will exploit others' vulnerabilities, even when an opportunity to do so arises. Trust, marked by the continuity of relationships between partners through a long sequence of repeated social or other interactions, has the characteristics of reinforcement, self-regulation, and induces some level of self-constraint. Trust implies the behavioral predictability of partners, the information availability of the partners usually leads to good behaviors, which confirms to expectations and functions to extend mutual benefits. That is, partners to the exchange make good-faith efforts not to take excessive and unilateral advantage of the other, even when an opportunity presents itself. Thus, because of trust, networking firms build a series of reliability-expectation relationships, which encourage actors to take the expected action, and affirm trustworthy behaviors.

In this paper, the author highlights the three fundamental bases of governance forms that exist; market, hierarchy, and trust.In certain contexts, the three are rarely completely distinct from each other, instead they overlap, intertwine, and juxtaposed each other and can be considered symbiotic. In other contexts, trust acts as an important governance form, independent of hierarchy and market. The paper is organized as followed: first, key definitions of trust and governance are reviewed; second, the strategic value of trust, particularly differentiated trust, is discussed; and third, we argue for differentiated trust as a governance form for networking firms. Finally, conclusions are drawn about governance structures in inter-firm networks and potential areas for future research are highlighted.

II. DEFINITIONS

2.1 Definition of Trust

Trust has continued to trend as a popular topic among researchers in management and organizational studies. However, while researchers concur that trust is important, there is little consensus in the management literature on how to define it. When common agreement is lacking around the definition of a term, the use of it as a construct is not very effective (Mentzer et. al., 2001). Some writers have drawn on personality theory and social psychology to describe trust in terms of individual expectations, behaviors, beliefs, and feelings. Others have drawn on sociology and economics, studying it as an institutional phenomenon. Trust is defined as equilibrium behavior (Casadesus-Mansanell and Spulber, 2005), which essentially means that trust occurs within the confines of social structures and these structures can nurture trust and offer efficiency. Another definition states "an exchange party worthy of trust is one who will not exploit others' exchange vulnerabilities.Trust is an attribute of relationship between exchange parties, trustworthiness is an attribute of individual exchange partners" (Barney & Hansen, 1994, p.176). The existence of vulnerabilities and the differing degree of vulnerabilities among exchange partners must be taken into account when considering the potential for exploitation as well as the level of trust reposed in any one party. Notwithstanding, trust is essential to facilitating social and economic interactions (Casadeus-Masanell& Spulber, 2005). In some instances, trust has been used interchangeably for risk-taking or cooperation (Lewis & Wigert, 1985; Zand, 1972). These varying approaches to studying the dimensions of trust highlight that trust can reside at a level or in a referent (Fulmer & Gelfand, 2012).

Although many different perspectives on trust exist, there is some convergence particularly around the idea of predictability. The notion of predictability implies that the behavior of others, including firms, will come with some level of expected mutual reciprocity, common values, shared goals, understandings and/or the willingness to forego opportunistic behavior. In this paper, trust is defined herein as confidence that one party to an exchange will not exploit or seek opportunities to exploit the other's vulnerability. However, given the multifacted and abstractional components of trust, this paper further draws upon a variant of trust, "differentiated trust" as a measurable construct and a means of creating enhanced strategic value in inter-firm networks. Differentiated trust, borrowed from cross disciplinary studies (Wang and Vassileva, 2003), is defined in this paper as reposing varying degrees of trust in firms, but under certain conditions and based upon validated evidence acquired about the firms' competence, level of involved risk, and the degree of collaboration among member partners. The conception of differentiated trust as a construct has gained attention in the fields of education, sociology, and computer science (artificial intelligence), but it has not been previously acknowledged in the business management literature. This paper integrates the concept of differentiated trust into the management literature and argues that it has utility for enhancing governance structures among inter-firm networks.

2.2 Definition of Corporate Governance

The standard definition of corporate governance among economists and legal scholars refers to the defense of shareholders' interests but with the separation of ownership and control. It therefore includes a set of promises that a corporation and its ownership makes to stakeholders. It is widely acknowledged that insiders may take actions that could potentially harm shareholders and several examples of such corporate governance failures exist.This basic agency dilemma has led to a possible definition of corporate governance as addressing both an adverse selection and a potentially hazardous problem that can have negative societal malfunctions.

In terms of good governance structure, the most viable structure will be one that selects the most able managers and makes them accountable to investors. Following this logic, most authors define governance structure addressing the following questions:

- How should directors be selected and compensated?
- How to monitor the tasks environment and the person involved?
- How to protect the interests of small investors?
- Should one encourage a market-based financial system for corporate control orshould a bank-based financial system be active in corporate control?

Clearly, such questions readily lead observers to ponder the comparative merits of various legal, fiscal, and regulatory environments, and the questions of selecting the most viable governance form: hierarchy versus market. However, this paper argues that such a traditional view of governance structure is too narrow a view for an economic and managerial analysis of corporate governance, especially one that involves inter-firm relations of networking firms. An expanded governance view must take into account a number of stakeholders who have innate relationships with and within the firm: employees, customers, suppliers, communities and various actors where the firm's plants are located, and so forth. These natural stakeholders have an increasing effect and constraint on firms. Taking into account the needs of knowledge-sharing and information co-exchange activities, detailed contracts and hierarchical control are neither effective nor efficient mechanisms for strengthening coordination and governance among networking firms.

III. THE STRATEGIC VALUE OF DIFFERENTIATED TRUST

Trust is vital for productive social capital, and through it, firms can develop friendly cooperative relationships, acquire the necessary complementary resources and other valuable resources, which are important to the survival and prosperity of firms. Trust comes from social networks and is embedded in social networks (Granovetter, 1985). The economic behavior of different actors is also embedded within complex social structures, which are closely associated with trust. With a framework of trust, inter-firm networks are developed as a form of cooperation to strengthen the competitive position and performances of firms within the network, through a sharing of specialized knowledge and resources. Repeated long-term transactions can be beneficial to partners because they increase opportunity-sharing availability and valuable information channels (Burt, 2009; Mohr and Spekman, 1994), which become the basis of co-value-creation of networking members. Foundational to these economic exchanges and relational activities is a sense of mutual trust. In a primary barter exchange system, the exchange partners must have some knowledge of the other party, understand the intention of each party, and then commence their exchange navigated through the reciprocity of knowledge and trust. Even in the modern economy, intermediated by money, there is a need for a sense of trust. If the sense of trust is diminished to a certain point, then every transaction must be closely supervised, which means that transaction cost would be high and economic transactions could pose undesirable challenges. Thus, trust creates the condition for firms that involves technically different and spatially separate problem-solving transactions, but not difficult bargaining condition (March & Simon, 1958).

More effective and efficient forms of governance for networking firms can be developed through utilizing trust-based mechanisms. Therefore, this author argues that the conventional view of governance structures must be extended to include alternative forms of governance such as differentiated trust, which takes into account the alignment and fit between partners in the firm (Ireland, Hitt, and Vaidyanath, 2002), while recognizing and creating conditions that reduce risk. Firms will repose a certain level of trust in other firms within the network based upon validated evidence acquired about members competence, the anticipated level of risk, and the degree of collaboration that will occur (see figure 1). What this allows members to do is to engage in trust behaviors following an assessment about other member partners across important dimensions. As a governance mechanism, differentiated trust can readily allow for firms within a network to accommodate the needs of other firms in the network without negatively affecting value creation in other firms within the network. Utilizing differentiated trust as a governance form can be effective in allowing inter-firm networks to operate with higher levels of flexibility, reduce transaction cost, and be more willing to engage in collaborations. These inter-firm networks must be effectively governed for social capital and knowledge to be built as well as sustained, and the starting point of trust building that lays the foundation for governance begins with firms in the network having a clear understanding of the competence of their partners.

If the exchange parties approach a transaction without considering the trust factor linked to thepredictability of the transaction's outcome, then the demands of each party are not likely to be fully met. Trust, therefore, influences economic behavior and allows for cooperation, without the direct influence of power or the market, especially if the conditions of turbulence and uncertainty exists. Under conditions of turbulence, power and market increasingly become a clumsy and awkward means to achieve co-operation in economic activities (Porporato, 2009). For example, in conditions of stability, it may be possible for a larger buyer to exert power and issue precise instructions on orders to be fulfilled by a smaller supplier firm. However, in conditions of turbulence, this approach becomes less feasible, because it is less likely that the buyer firm will know exactly what it wants, well in advance of when it wants it. Parties in the inter-firm network that subscribe to a trust form of governance will respond with flexibility and transparency to accommodate turbulence in the ecosystem that precipitated a departure in standard transactions. From the perspective of transaction cost economics, times of increasing economic uncertainty and turbulence increase the non-transparency of parties and consequently increase the potential for opportunism in economic exchange. This occurrence will likely defer others from undertaking economic activities in the future. By contrast, inter-firm networks governed by trust can continue to advance strategic cooperation and thus gain joint value maximization even under conditions of turbulence.

The transaction cost of exchange partners is lowered through trust because trust affects the performance and survival of membersin the network. In addition to trust having the ability to reduce transaction cost, it limits opportunistic behavior, reducesuncertainties in the future, facilitates efficient resource use, and thus improvesthe performance of the organization (Burt, Knez, & Powell, 1997; Robinson, 1996). Through ongoing interactions, firms in the network not only understand each other's intentions, but they can develop knowledge-based trust or equal standards (Shapiro, Sheppard, and Cheraskin, 1992), and over time they also develop differentiated trust, which is an expression of varying degrees of confidence in the inter-firm network, based on the firms' demonstrated competence and integrity.

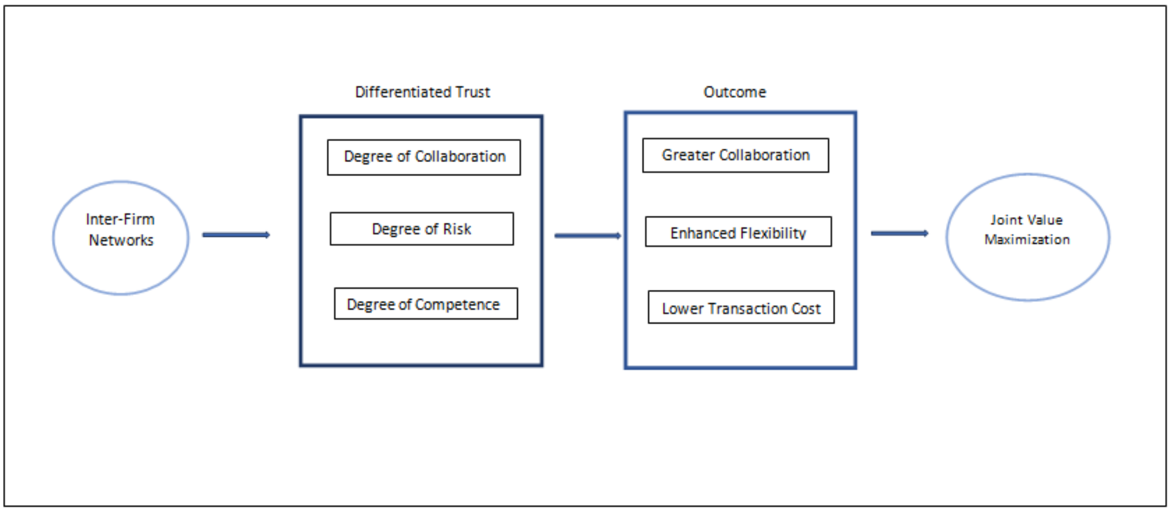

Figure 1

IV. DIFFERENTIATED TRUST AS A GOVERNANCE FORM IN INTER-FIRM NETWORKS

4.1 Conditions influencing choice of governance structures

Firms have the option of selecting different governance structures to manage their network. The motivational factors for allied firms choosing one specific governance structure over another has been discussed (Gulati and Singh, 1998): a hierarchical governance structure is generally selected when firms anticipate greater interdependence as well as when firms lack a strong command structure. Transaction cost economics and its associated conditions, focus primarily on appropriation costs that originate from the presence of contractual hazards. While appropriation costs can be an important concern, member firms in the network have other sets of concerns arising from coordinating cost, that is, costs closely associated with the likely interdependence of tasks across organizational boundaries and the complexity of the coordinating activities to be completed, whether individually or jointly. Because of the mutual awareness of potential benefits, member firms understand that if they behave opportunistically, it will increase the future co-coordinating costs. On the other hand, differentiated trust developed over long-term ongoing interactions between member firms acts as a lubricant for firms involving considerate interdependence, because the mutual awareness of the reciprocal benefits, and the procedures, routines and rules which are to be followed, not only mitigates the partners from behaving opportunistically, but also can decrease the possible coordinating cost between member firms. Therefore, differentiated trust embedded within this social structure can thus enable member firms of the network to work closely, if necessary, without the need for formal hierarchical control.

Given the attributes of trust, transaction-cost economics and associated conditions place their emphasis generally on single-party cost minimization, while the network involves the multi-relationships between different and diverse actors, this naturally raises the question of whose cost is minimized. Relatedly, networks are not only about cost-minimization, but also about joint value maximization. From this perspective, the transaction cost accounts generally concern the single-handed exchanges between actors but, in a large part,it leads to neglecting the procedural issues resulting from their ongoing nature. Above all, networks are usually not one-off transactions, rather networks entail ongoing exchange and adjustments, and thus reciprocate the member firms of the network. Therefore, the monitoring activity carried out against member firms is unproductive because of task complexity and strong interdependence between firms. Often, monitoring activities can corrupt the knowledge-sharing and information-exchange of the member firms, even though knowledge-sharing and information co-exchange activities are essential to the very success and existence of the network organization. Besides, supervision and control over the members in a network organization has dual effects. On one hand, it decreases the cost associated with opportunistic behavior. On the other hand, hierarchical control may produce adverse psychological effects, which may induce the probabilities of member firms to behave opportunistically.

Information Sharing

Building effective and trusting relationships with partners is pivotal for firms to acquire difficult to access information.Networking firms must understand the identity of future partners with respect to their competence, demands, or requirements, which involves having reliable information about their partners. Firms can connect through common partners and use these indirect connections as conduits of information. In general, valuable information is expensive, difficult to acquire in the public market, and not evenly distributed among closely associated firms. However, a firm can access this valuable information directly or indirectly through its associated partners. These indirect ties established for information and other regulatory functions can play a reference role as well as serve as mechanism for deterring opportunistic behaviors.Trust-based networking firms exchange information about their demands, competency, capacity, production, supply, development and quality (Antoldi & Cerrato, 2020).

Efficiency in social interactions is more easily attained when firms receives information about their partners through interaction with third parties than when they are atomized with no available information sources about each other (Jackson, Rogers, & Zenou, 2017). By participating simultaneously in a network initiated by third parties, two participating firms will have more chances to better understand and evaluate each other through the mediation and information provided by the third party and will thus have a higher chance of common interest gain. Also, the common actor with whom the two actors have a direct tie functions as a social control mechanism. For example, partners may free ride by limiting its contribution to the network or behaving opportunistically, which could have myriad negative consequences. However, it is incumbent upon networking firms to reduce risk to the lowest point when faced with challenges involving a breakdown in trust through intentional actions undertaken by partners in the exchange.

Reputation

Trust and reputation are symbiotic. The reputation about a firm embodies the information about the history, credibility, and other aspects of the firm, which indicates the internal and external perspectives attached to the firm, and these attributes tend to underpin perceptions about the firm. Time and resources are needed for a firm to accumulate and build its reputation, and firms in general take care to guard the positive reputation that they have built over a long period of time. Behaviors that positively reinforce reputation are directly under the control of each firm within the network. Member firms are expected to conform to the established rules and the expectation of other firms. The network has the capability to implement sanctions on the wrong behavior of the members. The members are cognizant that the network, as a whole, has the moral obligation to sanction opportunistic behaviors that may arise from its members. More important, the network establishes standards concerning behaviors, thus directing the member's action. The fear of loss of reputation deters firms linked by a common actor from behaving opportunistically against each other. By behaving reciprocally, an organization also can build a good reputation of being a good interaction partner as long as the behavior can be observed by third parties. This good reputation makes the firm very attractive as cooperative partners to a third party that may be looking for possible partners, even the third partner has no direct or indirect connections to the firm.

4.2 The reciprocity of trust

Reciprocal principle builds the structural constraint on self-opportunistic behavior. Thus, it serves to keep the present existing social capital within the network. According to reciprocal principle, the firm shows its partner the willingness to share the benefits of good economic opportunities in the future uncertain environments and bear the possible risks and costs associated with uncertainty. This willingness becomes the foundation of long-term relationships and trust, and it becomes much more critical when there is a higher level of conflicting interests present among parties. Under uncertain environmental conditions characterized by turbulent dynamism (Porporato, 2009), trust can improveadaptive capability based on joint utility maximization. Because networking firms are likely to engage in transactions in the future, thispossibility provides a basis for monitoring partner behavior to reduce any opportunistic behavior by the partners. This kind of mechanism serves as self-enforcing agreements, which are sometimes referred to as private ordering in the economics literature or trust in the sociological literature. These self-enforcing mechanisms rely on reputation as governance mechanisms and are often a more effective and less costly means of acquiring specialized and proprietary assets.

An important concern for firms entering network relations has to do with appropriation and relates to the predictability of their partners' behavior. A detailed contract is one mechanism for making the partners' behavior predictable, and another is trust. Both knowledge-based trust resulting from mutual awareness and deterrence-based trust resulting from reputation concerns create self-enforcing safeguards in an exchange relationship, and these features can substitute for contractual safeguards (Jackson, Rogers, & Zenou, 2017; Puranam & Vanneste, 2009). The member firms within the network internalize trust, and the predictability of the partners is built on the common standards, values and cultures of the network organization. As a result, where there is trust and in particular differentiated trust, appropriation concerns are likely to be mitigated, and organizations may choose not to rely on detailed contracts to ensure predictability. Thus, trust can be an alternative to detailed contracts because of ongoing interactive embedded relationships and social interactions between member firms of the network organization.

4.3 The cost of losing trust

The absence or lost of trust, concomitant to conditions that induce trust failure among network members,gives rise to opportunism in the sense that partners' vulnerabilities will become a target for exploitation (Adobor, 2006; Barney &Hansen, 1994). Thus, network members ultimatelyshare a concern about avoiding lost of trust and the implications for opportunistic behavior by partners. One way that parties address this concern is through the detailed contract, whichacts a mechanism for firms to forecast the future uncertain behavior of its partners. However, most detailed contracts cannot possibly cover all contingencies related to future uncertainties.

Trust-based relationships developed over a long-term ongoing interaction between partners become a central governance structure. Through ongoing interactions, firms not only learn about each other but also develop trust around norms of equity, or value of behavior, and common understanding based on a mutual value-maximization approach(Shapiro, Sheppard, & Cheraskin, 1992). The continuity of interactions between and among firms can serve as an important basis for enforceable or deterrence-based trust (Kreps, 1990; Shapiro, et al, 1992; Burt, Knez, & Powell, 1997). Given that some firms participate in inter-firm networks primarily to give legitimacy to their enterprise, while harnessing the synergies of collaborative associations, members of the network are cognizant that they stand to lose much once they undermine trust by behaving in self-interested ways. This recognition not only serves as a deterrence but it helps to enhance the trust and confidence of their partners. Potential sanctions include loss of frequent and repeated business transactions done with the same partner, loss of other nodes of interaction between the two firms, and loss of reputation, which could be difficult to rebuild.

There are strong cognitive and emotional implications for trust, which are perhaps most visible among individual members, and these personal relationships in turn exert pressures for conformity to expectations (Macaulay, 1963). When trust is applied in differentiated manner, the pressures exerted are much stronger when the degree of collaboration and level of involved risks are higher among network members. On the other hand, when the level of risk or extent of collaboration is lower among members, the notion of lost trust bears lower magnitude.

4.4 The embeddedness of economic transaction

Economic action, like any other form of social action, does not occur in barren social contexts but is rather embedded in social networks of relationships. Networks perspectives build on the general notion that economic actions are influenced by the social context in which they are embedded and that actions can be influenced by the position of actors in social networks. Embeddedness refers to

> "the fact and discussions within a group typically have a history, and thus history results in the routinization and stabilization of linkages among members. As elements of ongoing social structures, actors do not respond solely to individualistically determined interests … a structure of relations affects the actions taken by the individual actors composing it. It does so by constraining the set of actions available to the individual actors and by changing the dispositions of those actors toward the actions they may take" (Marsden, 1981).

Four primary forms of embeddedness exist: political, cultural, cognitive, and structural. At the center of the conception of embeddeness is structural embeddeness, which focuses on the nexus between business enterprises and the way that they are assimilated into networks in order to channel information exchange and learning (Taylor & Leonard, 2017). The quest for information to reduce uncertainty, a quest that has been identified as one of the main drivers of organizational action (Granovetter, 1985), is foundational to the thesis of embeddedness. Social factors resulting from the embeddedness of firms in a rich social context can be influential in altering the opportunity set perceived by firms. Thus, the social structure of ties within which economic actors are embedded can influence their subsequent actions. Network of contact between actors can be important sources of information for the participant. This in turn provides both opportunities and constraints for actors and can have implications for their behavior and performance. The influences of social networks can cause differences in resource availability between actors, enable difficult transactions, promote behavioral conformity by serving as conduits for both technological and social information about organizational activities, which in turn can influence the extent to which they adopt new innovations.

V. BRIEF DISCUSSION AND CONCLUSION

The trend of strategic alliances and inter-firm networks is in part driven by the need for independent institutions to share their individual areas of expertise and resources, to develop innovative products that will allow them to survive and thrive in competitions, while mitigating risks and uncertainties in dynamic turbulent environment. However, this move logically raises the question on how to regulate the behaviors of different actors, who may have different motives entering the network. Regulating through complex hierarchical and market governance structures can be interpreted as signs of less trust among network members. In this paper, we argue why trust, and differentiated trust in particular, can be an important alternative governance form in addition to hierarchy and market. The importance of differentiated trust in economic activity calls forth firms and their partners to build trust, but in a scaled manner, that will create conditions for greater collaboration, enhanced flexibility, and low transaction costs. Differentiated trust when applied within inter-firm networks takes into account the degree of competence that partners have, the degree of risk associated with their transactions, and the extent of their collaboration, which in turn allows members within the network to make reasonable predictions about how other network members will behave in the future. This has important implications for firms entering networks, as well as important implications for researchers and policy makers. To member firms of networks, the logical question is how to build trust between different partners that will enhance knowledge-sharing and promote information exchange, while diminishing possible risks associated with partnering. To policy makers, the central question arises on how to regulate the united actions of firms in the network that take actions as a unified team, given that external intervention may impede innovation and decrease flexibility within the network. For researchers, this paper offers opportunities to analyze the governance structure of dynamic, continually changing inter-firm networks across different industries when trust is applied in a differentiated manner.

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