Working Paper No. 38

Business Partnerships in a Globalising World: Economic Considerations

by

Clem Tisdell

December 2005

THE UNIVERSITY OF QUEENSLAND
Business Partnerships in a Globalising World: Economic Considerations†

by

Clem Tisdell∗

December 2005

† A draft paper prepared for 2nd French-Australian workshop on managerial science and economics to be held at Mauritius University, 23 and 24 January, 2005. The theme is “Partnership and Globalisation”.

∗ School of Economics, The University of Queensland, Brisbane QLD 4072, Australia
Email: c.tisdell@economics.uq.edu.au
BUSINESS PARTNERSHIPS IN A GLOBALISING WORLD:
ECONOMIC CONSIDERATIONS

Abstract

Begins by considering how neoclassical and mainstream economists have modelled the business firm and outlines briefly the evolution of economic thought and that of managerial science about institutional structures involving firms, hierarchies, markets and interfirm cooperation. Subsequently, taking into account this thought, it considers whether growing economic globalisation is likely to result in more frequent business cooperation between firms, what types of alliances may be favoured, and why. Both factors favouring increased business cooperation as globalisation proceeds, as well as those that may retard it, are discussed.
BUSINESS PARTNERSHIPS IN A GLOBALISING WORLD:
ECONOMIC CONSIDERATIONS

Introduction
Neoclassical and mainstream economists have given little attention to the institutional structure of business firms and have virtually ignored possible partnerships and cooperation between firms. Cooperation between business firms is generally only discussed in standard economic texts as a “desire to restrict competition and features in chapters about price agreements and market sharing” (Richardson, 1972, p.883). However, as Richardson (1972, p.895) points out, “the dichotomy between firm and market, between directed and spontaneous coordination is misleading; it ignores the institutional fact of interfirm cooperation and assumes away the distinct method of coordination that this can provide”.

The main issue discussed in this paper is whether globalisation is liable to encourage the formation of business partnerships; if so, why, and what forms such partnerships are likely to take. However, before considering these matters, it is useful to consider briefly the evolution of economic thought and that of management science about institutional structures involving firms, hierarchies, markets and interfirm cooperation, consider how firms can cooperate (that is forms of interfirm business cooperation and why they cooperate. The latter will provide some guidance about how globalisation might encourage the formation of business partnerships.

2. Institutional Structures – Firms, Hierarchies, Markets and Interfirm Partnerships
In neoclassical economics and in most standard microeconomic texts, the institutional structure of business firms is ignored. The firm is assumed to be able to maximise its profit without any difficulty and the firm has been described as a device or abstraction to facilitate the discussion of the market or price systems by neoclassical economists (Pitelis, 1993, p.7). Neoclassical economist place most of their emphasis on the workings of markets not on administration involving hierarchies or business firms.

The position began to alter in the latter part of the 20th century, particularly as a result of the work of Williamson (1975). Although his focus was foreshadowed by Coase (1937), Coase’s work had little impact until Williamson (1975) extended it greatly using a transaction cost approach. The historical development of this line of thought has been succinctly outlined by
Kay (1993) and it has given rise to a new line of economic thought which has been called ‘neo-institutionalism’.

A hallmark of this approach is its recognition that even in market economies and just taking account of the private sector, much resource allocation and development activity occurs outside the market system. It occurs within hierarchies; of which business firms are one. The market does not coordinate all economic activity. Much economic activity requires direct managerial intervention.

The type of transaction cost economics associated with neo-institutionalism resulted in issues such as the following being addressed: how do transaction costs influence the size of the firm; how do they influence or make or buy decisions, what type of managerial structures will minimise transaction costs in large firms, how can principal-and-agent problems be addressed in public companies and so on. Thus, the firm as an institution and its relationship with markets became the prime focus of neo-institutional economists.

While this new focus was a valuable addition to economic thought, it failed to go far enough in considering non-market institutional arrangements that help govern resource use and economic development. It left out of account interfirm cooperation. The theory continued to make a sharp dichotomy between resource-use decisions made within the firm and those coordinated by the market with little or no attention to interfirm partnerships. Nevertheless, by the mid-1990s, Williamson (1994) did find it necessary to give some attention to interfirm cooperation because for one thing, there was considerable speculation in the United States that the international competitiveness of Japanese industry might have its roots in the widespread practice of interfirm cooperation by Japanese firms (Williamson, 1994). Yet the study of interfirm cooperation and partnerships did not become a central focus for O.E. Williamson.

Williamson (1994) continued to claim that economising was the major influence on the structure of economic organization and that business studies concentrating on ‘strategizing’ lacked relevance and focus. On the other hand, Gulati (1995) has argued that an analysis of the structure of economic organization based purely on economising is too narrow. He states, for example, that “neither transaction costs nor social factors should dominate discussion of
alliances and that in the final analysis, any explanation should encompass both” (Gulati, 1995, p.108).

While there is increasing interest in economics in business alliances and networks (see, for example, Haugland and Gronhaug, 1996), economic studies of this subject are still in their early stages. This is despite the recognition of their importance by Richardson in an article that appeared in *The Economic Journal* in 1972.

Figure 1 provides a schematic representation of the evolution of economic thought about the analysis of economic organization. It illustrates the growing attention first to the nature of firms and their institutional structure and then to interfirm institutional relationships involving varied types and forms of business cooperation.

**Figure 1** Stages in the analysis of the organisation of industry showing increasing relative attention to the institutional structure of individual firms and subsequently to non-market relationships between firms, that is, forms of interfirm cooperation. The relative size of the figures indicates the degree of attention given to institutional factors.
Interfirm cooperation can take a variety of forms, and may vary in extent and intensity. It may involve formal contractual arrangements (or similar arrangements) or be informal. It need not be hierarchical in nature. In some cases, it evolves through continuing business contact which develops a code of mutual obligation between business partners.

Formal types of business cooperation include franchising and joint ventures in a particular product area or geographical region. Such joint ventures may occur in relation to marketing, production or R&D. They may also involve reciprocal preferences in trading. For example, a buyer may give preference in purchasing supplies to a particular seller or sellers and vice versa, a seller may prefer a particular buyer. As a result both buyers and sellers may reduce their market transaction costs. If the reduction in transaction cost goes mainly obtained by one set of traders, say sellers, then they may sell at a discount to a regular buyer that displays a preference in purchasing their products.

As discussed elsewhere by Tisdell (1996, Ch.13), buyers and sellers may find it mutually advantageous if they have a partnership to exchange information about market requirements, new technologies and so on. Much exchange can be two-way but often the bulk of information is provided by the largest enterprise in the cooperating groups of firms.

3. Why does Interfirm Cooperation Occur? What are the Obstacles?

Transaction cost economics takes the point of view that industrial organization tends to alter in a way that promotes economic efficiency particularly by minimising transaction costs. However, as suggested by Gulati (1995), this may be a rather narrow view.

The following appear to be some of the reasons why businesses may want to form partnerships:

(1) To achieve a reduction in market transaction costs.
(2) To make greater economic use of different sets of knowledge available to potential partners; for example, about the market.
(3) To enable greater advantage to be taken of economies of scale or scope by expanding the size of operation of partners.
(4) This may also facilitate greater specialisation and division of labour between partners.
This may enable partners to employ more specific assets. Because of reduced market variation and uncertainty, less flexibility may be needed in business operations and as a hedge against uncertainty.

Cooperation may enable partners to exploit synergies in R&D and in marketing.

If learning by doing is important, it is also possible that a large buyer may favour a particular buyer or small set of buyers in order to accelerate learning by doing within supplying firms. This is akin to the infant industry agreement sometimes advanced in favour of temporary trade protection.

Most of these reasons for business cooperation have been given limited consideration by economists. For example, Hayek (1945) argued that price is the only information that economic agents need to know to operate efficiently and maximise their profit. Consequently, the market system can coordinate economic activity effectively using little information. However, this assumes well defined homogenous products. In practice, variations of the same product are often required to meet demands in different markets, and one must also consider efficient ways of seeking buyers. Thus efficient ways of seeking commodities requires much more market information than claimed by Hayek (1945) and mainstream economists, as has, for example, also been pointed out by Sawyer (1993).

In any case, there is much empirical evidence to suggest small and medium firms often cooperate with larger ones to obtain greater market access. For example, a survey of several hundred small-medium sized garment manufacturers in Jogjakarta, Indonesia completed by Latif Adam (2005), revealed that the most frequent reasons given for their cooperation with larger enterprise was access to markets. Although less frequently mentioned, extra access to credit (finance) and to new technologies were also mentioned. Larger firms generally had wider and more specialised knowledge of markets for different types of garments, and used this when putting out orders to subcontractors.

The fact that economic gains may be available to firms as a result of economic cooperation does not mean that cooperation will occur (see Tisdell, 1966, 1996, Ch.8). For one thing, there may be lack of trust between potential partners. A business partnership can jeopardise the economic future of one or both partners if one (or both) proves (prove) to be untrustworthy. The importance of trust for the formation of business partnerships has been stressed by Aurifeille and Medlin (2005).
McAllister (1998) provides an in-depth review of the literature on trust as a foundation for organizational cooperation, and Das and Teng (1998) specifically explore types of mechanisms that may be used to develop business confidence and trust as a basis for cooperative business partnerships. They also emphasize the importance of adequate control mechanisms as a means for establishing lasting cooperation. Granovetter (1985) points out that since about 1970, many institutional economists have become interested in trust, malfeasance and ‘opportunism’ in economic relationships but he is critical of the manner in which they have dealt with the subject. In general, Granovetter (1985, p.482) objects to the emphasis of “new institutional economics” (represented, for example, by North and Thomas, 1973; Williamson, 1975) that organizational structures arise primarily from “the pursuit of self-interest by rational, more or less atomized individuals”. In Granovetter’s view, while this may explain the evolution of some organizational forms, it is a special case because it ignores social and cultural embeddedness. Therefore, he favours a wider approach of the type adopted, for example, by Max Weber (Granovetter, 1985, p.507).

None of the above mentioned approaches mention efficiency or the competence of potential partners as an important consideration in the formation of business partnerships. However, if one partner is competent and capable and the other not, a partnership is unlikely to last.

Thus, secondly, the economic efficiency or capability of a partner also has to be taken into account if lasting cooperation is to be achieved. If a partner is trustworthy but not efficient and punctual, this can put a partnership at risk. Ideal partners should be efficient/capable compared to others in the industry, and be trustworthy.

Determining whether a potential partner is efficient and trustworthy is not straightforward. Usually repeated contact with partners is needed to establish this. Gulati (1995) suggests that most business partnership evolve from repeated business contact, and alliances are likely to be less formal the greater the number of previous alliances that partners have had.

4. Does Globalisation Stimulate the Formation of Business Partnerships?
Globalisation involves the extension of markets worldwide. From the point of view of an individual business, this has two somewhat different consequences: (1) It increases the degree of market competition that they face; (2) It extends the potential size of the market for the
firm’s products. Thus, as briefly discussed by Svizzero and Tisdell (2002), economic globalisation may stimulate both defensive and offensive (strategic) business behaviour, for example, in relation to R&D.

If potential business partnerships exist that could enable partners to better meet increasing competition, then the economic incentive to form them will increase as globalisation proceeds. These partnerships are essentially defensive ones. They are more likely to be formed by firms in the same country than between firms in different countries but the latter may also occur. The available evidence suggests that international partnerships are more difficult to establish successfully than national ones. This may be because there is greater knowledge of the qualities of potential national partners, cultural differences are less marked, and communication may be easier than in alliances involving international partners. However, the possibility of forming business a partnership is not the only possible means to cope with increased competition. For example, an alternative may be to reduce such inefficiencies as exist within the firm.

A second possible reason for forming a business partnership as globalisation proceeds can be to more actively penetrate the larger available market. Such partnerships are more of a strategic nature than of an economic efficiency nature. They may, for example, exploit synergies in R&D or marketing of partners. Because of the larger market, the potential payoffs from successful cooperation of this type rise as globalisation evolves.

Although the economic incentive for forming defensive and pro-active business partnership rises with growing globalisation, obstacles to establishing successful business partnerships remain. These obstacles include uncertainty about how trustworthy potential partners are and how efficient they are, or could potentially be. Considerable asymmetry of information exists. Globalisation does not reduce these obstacles. Furthermore, the cost of a failed partnership when globalisation is well established is liable to be much greater than when markets are relatively protected. Therefore, firms may be wise to be particularly cautious about forming new partnerships once globalisation becomes well established.

Gulati (1995) suggests that it may be more difficult to form business partnerships between firms from difference nations than in the same nation. He develops the hypothesis (Gulati, 1995, p.95) that alliances are more likely to be equity based if they are among firms of
different nations. He is able to provide empirical evidence to support this hypothesis. Equity based forms of alliances seem to be more common when the gains from cooperation are uncertain.

If companies are multinational in nature and have subsidiaries in foreign countries, this may assist the formation of international partnerships. A subsidiary may have considerable knowledge about possible reliable partners in the country where it is located. Apart from seeking alliances of its own in its country of location, a foreign subsidiary may act as a go between for its parent company or other subsidiaries that wish to establish alliances in its country. Nevertheless, increasing globalisation will probably do more to simulate the formation of business alliances within a country than between countries.

It is possible, however, that greater access to foreign markets could stimulate the formation of business partnerships for the marketing and distribution of imports in foreign nations. Many commodities require effective marketing and distribution of foreign countries if they are to tap their markets. To some extent marketing and distribution must be tailored to local conditions if significant market penetration is to be achieved. A local trading partner may be best placed in terms of local knowledge and contacts to market and distribute a foreign company’s products. As the volume of international trade rises, as it has done substantially in recent decades (Tisdell, 2005; Tisdell and Sen, 2004), one would expect the number of international trading and marketing alliances to increase.

5. Concluding Comments
Neoclassical and mainstream economists have not given much attention to the institutional nature of economic organization. However, interest in this subject has increased. This interest has been simulated by the development of neo-institutional economics in the last part of the 20th century. The dominant stream of neo-institutional economic developed by Oliver Williamson relies on the hypothesis that structures of economic organization evolve to achieve (maximum) economic efficiency. In particular, it is considered to be likely that economic institutions will evolve that will minimise transaction costs. That presumably would also apply to forms of business cooperation.

Nevertheless, not all business partnerships form which could potentially benefit all their partners. Very often, as discussed by Tisdell (1966; 1996, Ch.8), coalitions fail to form that
could bring about a Paretian improvement for all the partners, that is, make at least some partners better off without making any partner worse off. There are several reasons for this as outlined, for example, in Tisdell (1996, Ch.8) but lack of trust can be a major obstacle (Gulati, 1995). Uncertainties about payoffs may also be a stumbling block. Furthermore, alliances by their nature limit the behaviour of participants and can create specificity of assets. Some firms may therefore be hesitant about entering into interfirm cooperation because they are afraid of being locked into a particular development path (path-dependence) as a result of such cooperation.

While the trustworthiness of partners is a major influence on whether business partnerships form and survive, adequate trust is not sufficient for lasting alliances. The size of the economic benefits form the synergistic relationship of businesses will be important as well as the relative economic competence of each of the parties to a cooperative business arrangement. If a party is trustworthy and economically inefficient compared to other economic agents, an alliance is likely to fail. It may fail economically because it is less competitive than other partnerships of a combination of more efficient businesses. Or it may be terminated by the more efficient partner(s) because this partner (they) seeks to replace less efficient partners with more efficient ones. In considering this matter, the more efficient partners will most likely assess the dynamics of the efficiency of their less efficient partners, for example, whether these partners are likely to increase their economic efficiency as a result of, for instance, learning or under pressure from the efficient partners, and how quickly. Business partnerships are probably not dissolved quickly, at least not before considering whether they can be salvaged. In any case, the relative economic efficiency of partners needs to be considered as an influence on the formation and survival of business partnerships, and as a factor in their economic competitiveness in a globalising world.

It has been argued that economic globalisation does provide a stimulus for the formation of business partnerships. They can provide (1) a defence mechanism against increased market competition arising from globalisation and (2) can act as a vehicle to exploit enhanced market opportunities arising from globalisation. However, business partnerships are not always an effective means to cope with or take advantage opportunities provided by economic globalisation.
A poor partnership is likely to be worse economically than none at all. Therefore, it is still necessary to proceed cautiously in entering new partnerships as globalisation becomes more pervasive. In fact, a failed partnership may be more damaging to a business in a highly competitive environment resulting from globalisation than in a less competitive one. Therefore, even though there are greater economic incentives for entering into business partnerships in a globalising world, businesses have to be increasingly cautious about entering into partnership agreements as globalisation grows.

6. Acknowledgements
I wish to thank Dr Glyn Edwards for assisting me with a literature search.

References


