

Relational Contracts

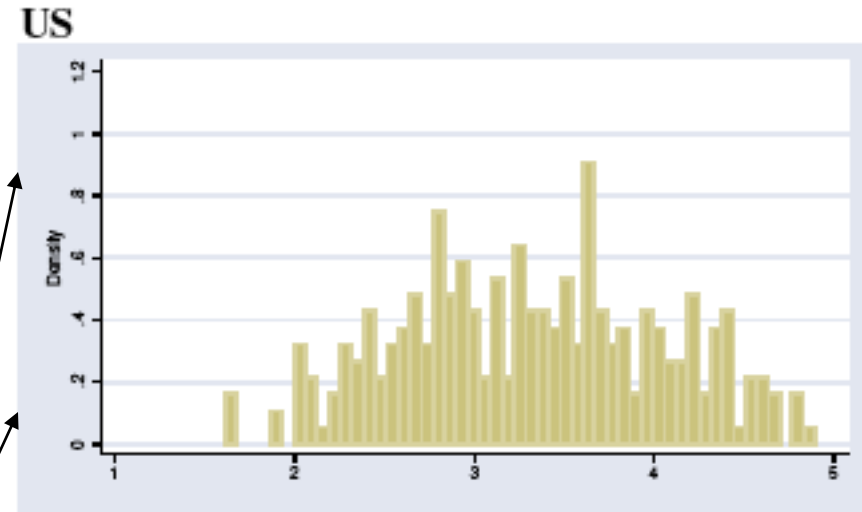
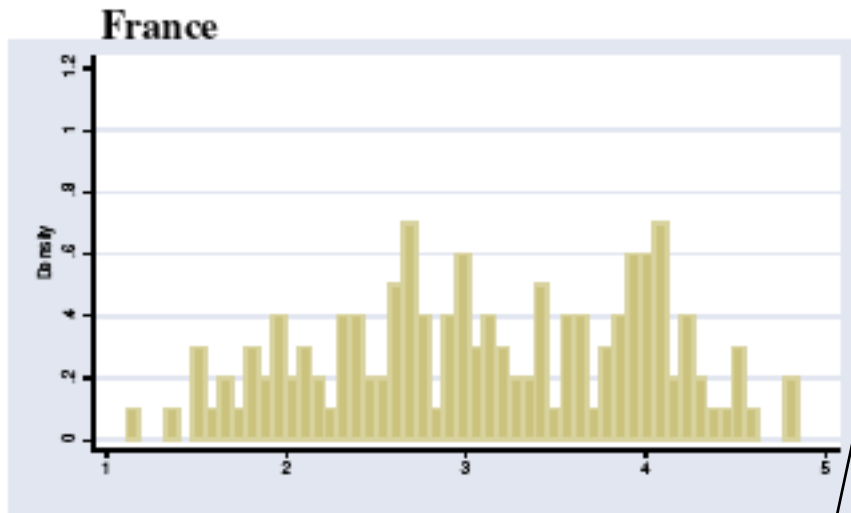
Does integrity matter & can trust be designed?



Rebecca Henderson, MIT Sloan School

***Drawn from joint work* with Robert Gibbons, Nelson Repenning and John Sterman, all also of the Sloan School**

What drives variation in management practice across firms?

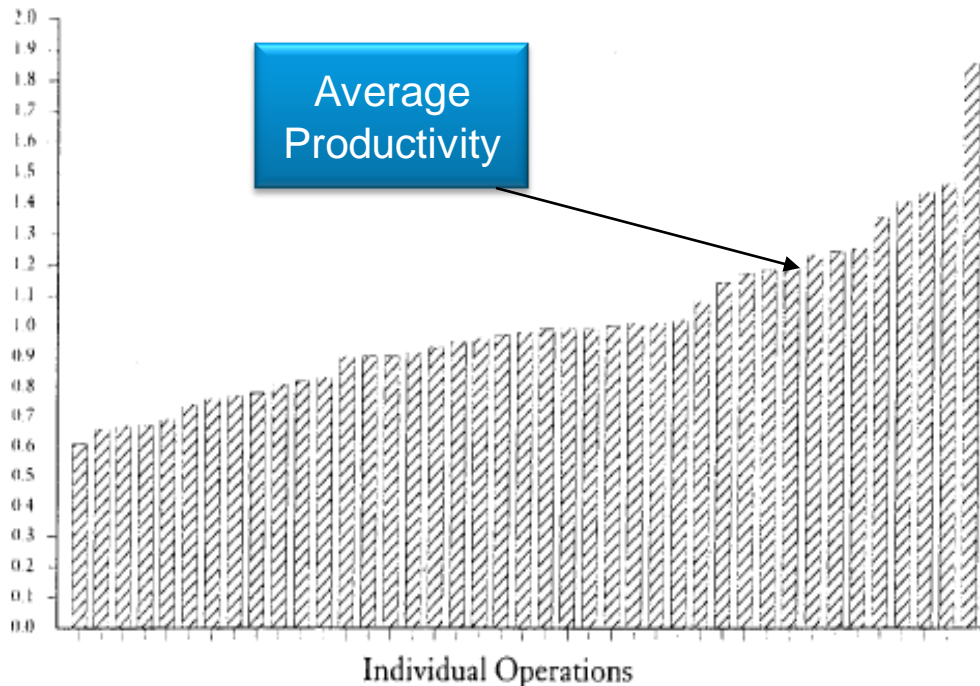


Average of 18 questions
scaled 1 to 5 for
135 French firms,
290 US firms

Bloom-Van Reenen QJE 07

What drives variation in management practice within firms?

Figure 5-1 Multifactor Productivity Index



Multifactor productivity index computed as standardized output (meals & set-ups) divided by standardized inputs (labor & capital costs). Average plant has productivity equal to 1.

All 40 sites are very similar along multiple dimensions: located in the US, employ low-skilled labor, utilize same technology, serve similar customers, produce similar products.

The most productive plant is 3 times as productive as least productive plant

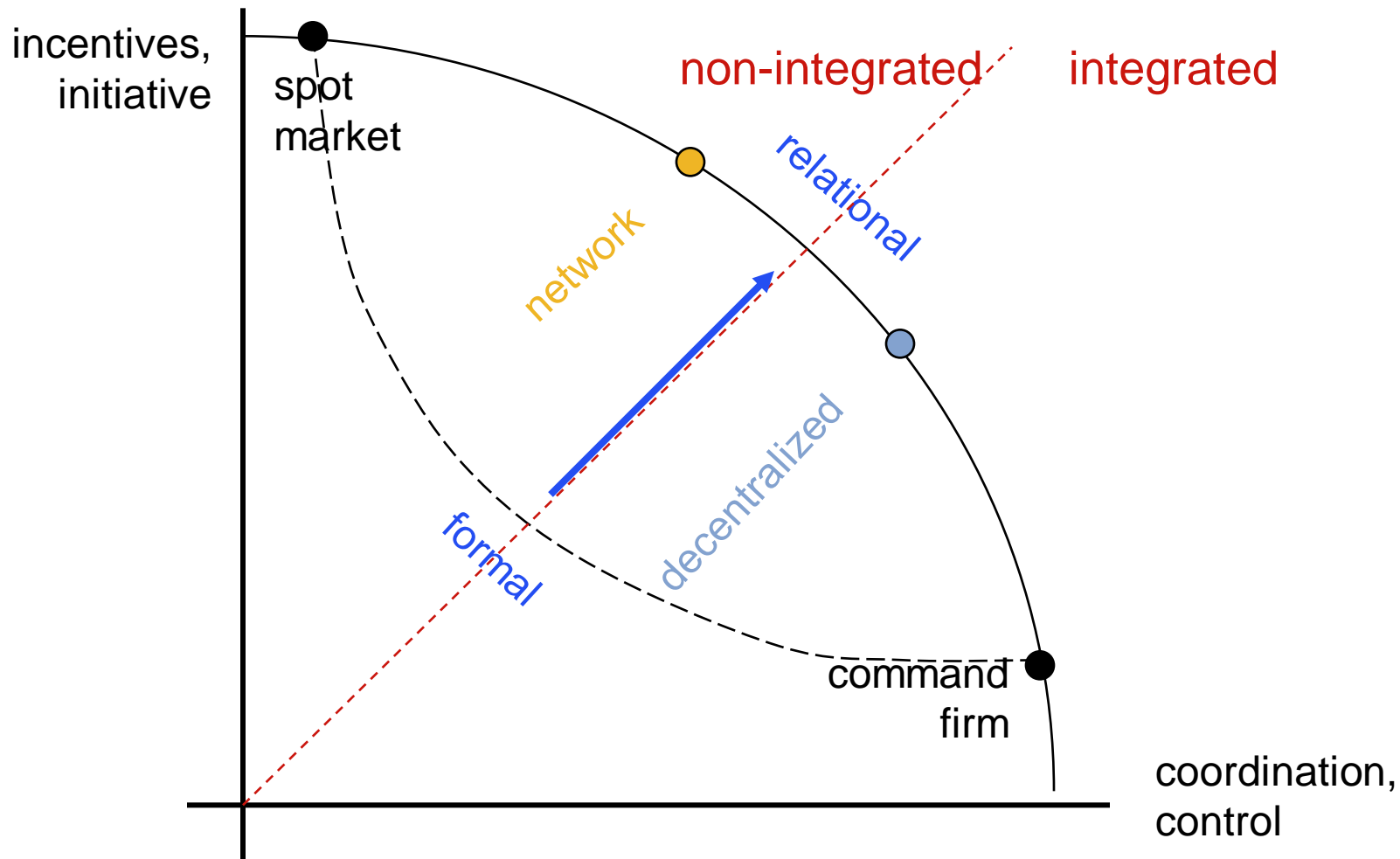
After using regression analysis to adjust for local labor markets, size of local market, unionization, age of equipment, product quality, and local monopoly

Still find large performance differences on the order of 2:1

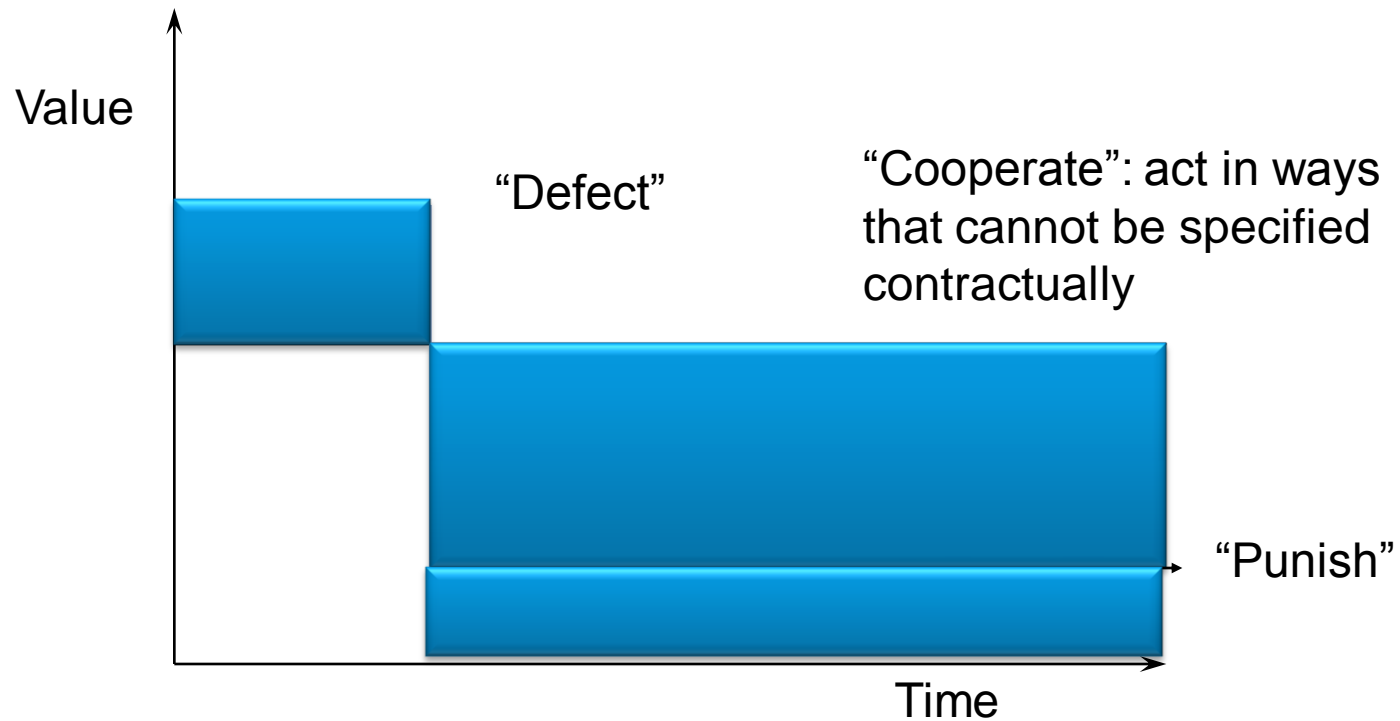
Chew, Bresnahan and Clark, 1990

Could it be differences in relational contracts?

Relational contracts mediate between spot markets and bureaucracy



Relational contract basics



Nordstrom's relational contract

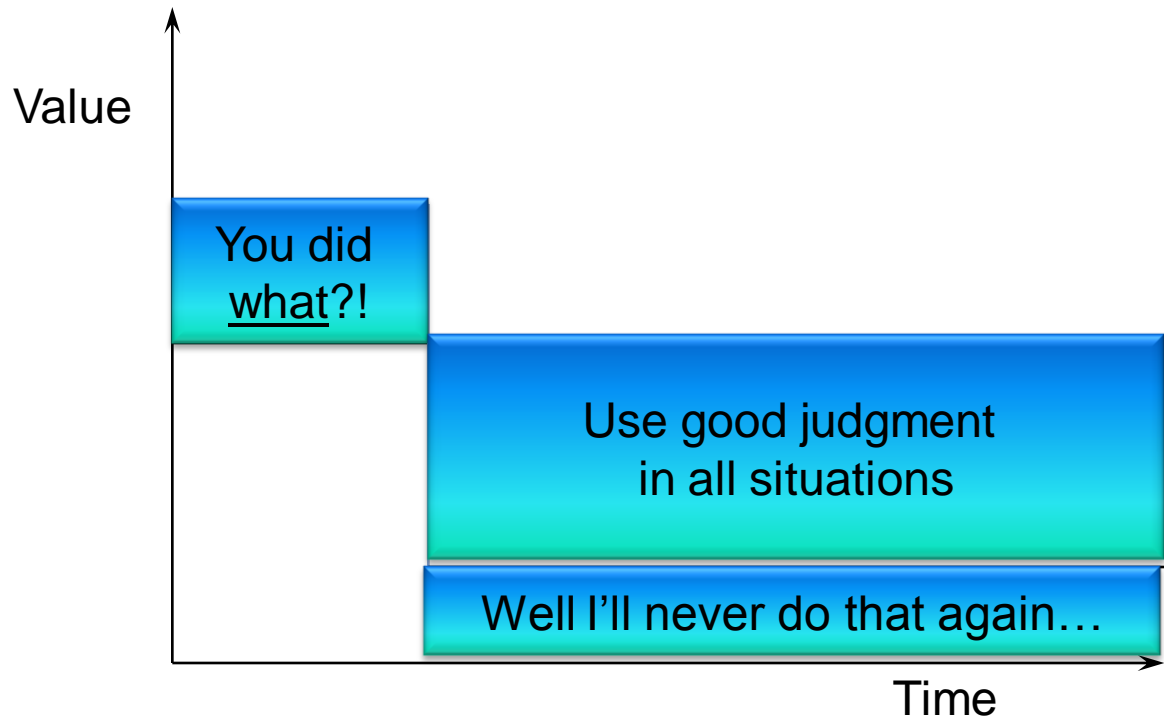
Welcome to Nordstrom

We're glad to have you with our Company. Our number one goal is to provide outstanding customer service. Set both your personal and professional goals high. We have great confidence in your ability to achieve them.

Nordstrom Rules: Rule #1: Use good judgment in all situations. There will be no additional rules.

Please feel free to ask your department manager, store manager, or division general manager any question at any time.

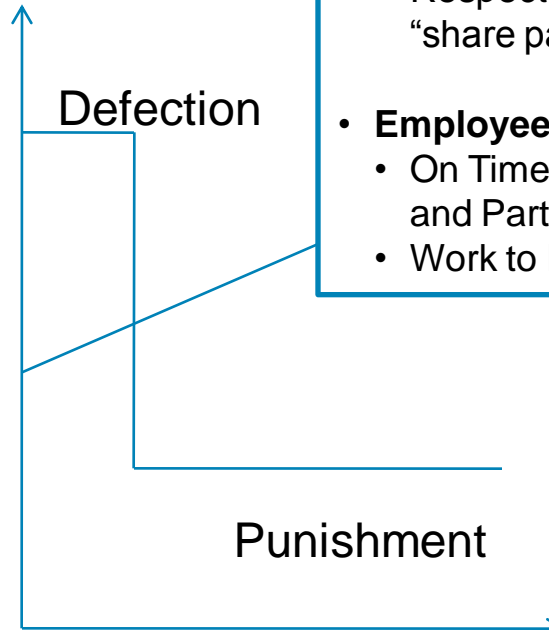
Relational contracts at Nordstrom



Nucor Example (1)

Defection

- **Company:**
 - Layoff or cut performance pay in bad times (ex. To offset rising steel prices)
 - Neglect to Manage share price (impacts 401K, profits sharing)
 - Implement Executive Perks
- **Employees:**
 - Act as individual versus team member
 - Late, poor quality, disruptive, etc.



Cooperation

- **Company – “We will Treat you Well and Fair”**
 - Pay well for performance
 - No Layoffs – Even During Hard Times
 - Respect employees – Management will “share pain” in hard times
- **Employees – “Do the Right Thing”**
 - On Time, Productive, Professional Behavior, and Part of a Team
 - Work to Maximum Productivity

Punishment

- **Company:**
 - Every person acts for themselves
 - Threat of unionization by employees
 - Loss of productivity
- **Employees:**
 - Peer pressure to leave
 - Loss of performance pay
 - Lower returns in 401K / Profit Sharing Plans

Nucor Example (2)

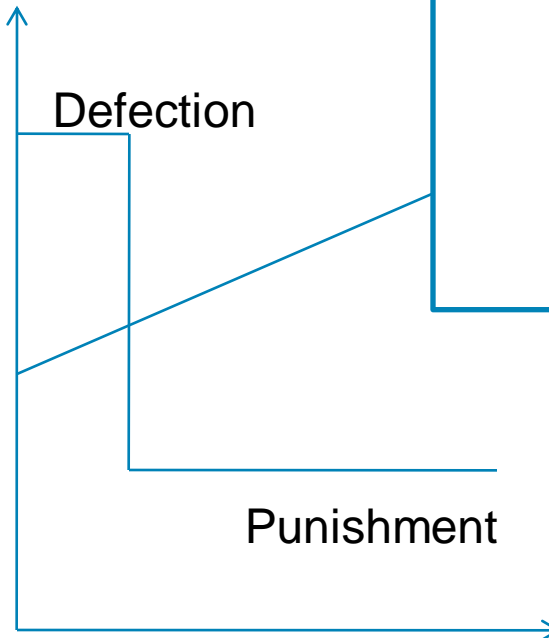
Defection

•Company:

- Won't provide earned bonus
- Micromanage plants and have will have significant centralized, corporate involvement

•Managers:

- Focus on individual plant performance
- Don't maximize assets or focus on efficiency
- Won't share key learning's with other plants



Cooperation

•Company

- Allow decentralized management structure
- Will not micromanage but allow to operate autonomously
- Reward you for results based on ROA

•Manager

- Maximize assets of the plant
- Assist other plants with best practices and troubleshooting
- Focus on efficiency, technology and best practices within the plant to achieve low cost strategy
- Continuous Improvement

Punishment

•Company:

- Best practices will not be shared across the plants
- Overall loss of productivity and profitability

•Managers:

- Earn less money
- Threatened job security

So.... Trust is a good thing?

Possibly interesting questions:

- Are “high trust” organizations always at an advantage?
- Can relational contracts simply be “declared”?
 - Building clarity
 - Building credibility
- What would it imply to think of relational contracts as a design parameter?