Working Paper

Equity within network relationships

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Abstract

Within some relationships between network members there is an issue of which of the parties exercise power but also why some parties appear to be willing to accept subservient roles. This paper will consider the possibility that an apparently subservient role may be acceptable to a party because of their perception of the equity of their situation but also because of the lack of realistic alternatives.

Introduction

The IMP Group states that 'the atmosphere' is one of the four basic elements that it uses when analysing industrial marketing and purchasing situations. The view of the IMP Group is that: "the atmosphere is built up by specific episodes of exchange as well as by the long-term process of interaction" (Turnbull and Valla 1986, p. 6) and that it determines the degree of stability within which exchanges occur. Much of this stability comes from the existence of norms that result in "regular behavior patterns that are relatively stable and expected by a group's members" (Bettenhausen and Murnigham 1991, p.21). However this stability is dependent on the parties involved accepting that the outcomes of their relationship are equitable[1]. Indeed Macneil's (2000) common contract norms include: *The linking norms: restitution, reliance, and expectation* interests. '*restitution'* is part of this norm because it is understood that, after an agreement has been reached to make an exchange, it may be recognized that one party is gaining unfairly from the exchange and thus adjustments may be necessary.

Background

A feature of some of the buyer-supplier relationships[2] found within networks is the sense of both observers and of the parties involved that in some cases one party is dominant (see for example: Kumar, Scheer and Steenkamp 1996; The Competition Commission 2000; Corstein and Kumar, 2005). This is not a new perception. For example, fifty years ago it was observed that: "power has come to rival economic factors as the governing element in the vertical relationship of distribution" (Palamountain 1955). 'Power' is the ability of one party to influence another party to act in way that they would not have done if left to themselves (Thompson 1956; Emerson 1962; Crozier 1963) and this ability "usually implies a continuous relationship, in which a substantial sanction is always present." (Beetham 1991, p.44)

While the argument for the existence of relationships is that "the partners create unique value that neither party can create independently" (Corstein and Kumar 2005, p.80) the distribution of this jointly created value is an issue which needs to be addressed (see for example: Campbell and Harris 1993; Kumar, Scheer and Steenkamp 1996; Zajac and Olsen 1993). Indeed where one party is dominant then there is the possibility they will exploit the other (Kumar, Scheer and Steenkamp 1996, p.54). Yet, in spite of some implicit and some, but rare, explicit complaints[3] by

[1] An anonymous reviewer argued that: "It seems rather obvious that the equity concept (or close notions such as 'fairness' and 'justice') cannot be applied in the analysis of business relationship, at least if one acknowledges their nature." The difference between this reviewer's views and those expressed in this paper may be based on a disagreement as to what 'a business relationship' is. Arguably the reviewer 'defined away' the problem that this paper seeks to investigate.

[2] For simplicity this paper will be limited to the discussion of buyer-supplier relationships. However, the issue of inequity can arise between any two parties within a network. For example, the issue of equity can arise between two firms which, while they are not competitors, both supply a third firm.

[3] Even where explicit comments are made those making them are typically unwilling to be named. The UK Competition Commission found this when investigating allegations of aggressive behaviour by supermarkets towards their suppliers. It stated: "Most suppliers were unwilling to be named, or to name the main party that was the subject of the allegation. There appeared to us to be a climate of apprehension among many suppliers in their relationships with the main parties." (Competition Commission 2000, p.6)

suppliers about being dominated there are few public records of suppliers withdrawing from their long-term relationships with major customers. An exception to this was the decision of Coates Vyella, one of Marks and Spencer's three largest suppliers, to stop supplying Marks and Spencer[4]. Does this therefore mean that these complaints are no more than suppliers' public posturing, the intent of which is to suggest to their customers that they might decide to 'exit' the relationship? Alternatively are there some other aspects of the manner in which firms evaluate their relationships that account for their apparent stability even where the other party is dominant? It will be argued that examining relationships from the perspective of 'equity', seen as a dynamic process, provides some potentially useful insight into these situations.

Equity

The concept of something being 'equitable' is complex and there is clearly a risk here in merely substituting one 'difficult to define' concept, namely 'power', with 'equity' which is another 'difficult to define' concept. However, 'equity' can be defined as a principle where each party expects to gain benefits from a situation in relation to its inputs (Jap 2001). Equity theory postulates that actors consider whether or not this ratio of benefits relative to inputs is out of balance (Frazier 1983) and then compare their cost-benefit ratio with relevant others (Frazier 1983; Anderson and Narus 1990). However, an important feature is that these inputs "are *as perceived by their contributor*[5] and are not necessarily isomorphic with those perceived by the other party to the exchange. This suggests two conceptually distinct characteristics of inputs, *recognition* and *relevance*[4]." (Adams 1965, p.277) Furthermore, "(i)n a manner analogous to inputs, outcomes are *as perceived*[4], and again, they should be characterized in terms of recognition and relevance." (Adams 1965, p.279)

Although it might be argued (Adams 1965, p.279) that there exist normative expectations of what constitute 'fair' correlations between inputs and outcomes, as will be discussed, a party's expectations are very dependent upon with whom they choose to compare themselves. Inequity exists for one party whenever they perceive that the ratio of their outcomes to their inputs is unfair in comparison with the ratio of some other party with whom *they* believe it is relevant for them to compare themselves. However, there are two critical questions. The first is who they chose as the comparator – should, say, a supplier compare themselves with their customer; with their competitors; those firms which supply their customer with non-competing goods; or, some other party? Indeed disputes between partners about the equitability of their relationship can arise from the simple fact that one party in a relationship does not feel that the other party is using an appropriate comparator. The second critical question arises as a result of the recognition that there will be some variation in the value of the ratios over time. The question that therefore arises is for how long a party can be expected to accept what they perceive to be an inequitable situation, for the existence of significant unevenness for a prolonged period can be expected to cause problems for the continuance of a relationship (Macneil 2000).

In the context of a vertical channel the principle of perceived equity would suggest that a supplier might accept a customer's power over it so long as the supplier believes that it is being treated no less badly than any firms with which it compares itself[6] and

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[4] It might though be argued that this action has to be seen in the context of Marks and Spencer's earlier unexpected and very public change of its view of the value of 'relationships' (Blois 2003a).

[5] Emphasis in original.

[6] Arguably these would most typically be competitors though not necessarily competitors dealing with the same customer.

a/ cannot see any other way of obtaining the same benefits for less sacrifice; or,

b/ greater benefits for the same sacrifice.

Reactions to perceived inequity

Where an inequity is perceived to exist one or other party will take action to try to rectify the situation. These actions may be initiated by either the aggrieved party and/or the other party (Greenberg 1990). That the aggrieved party will seek to take action is obvious but once the other party is aware of their partner's perception that there is an inequity it may, for a variety of reasons, believe it to be in its best interests to seek to appease the aggrieved party. Indeed it is important to recognize that a dominant customer may decide to take action to reduce a supplier's perceived inequity even before it becomes a significant issue. The customer might for example know that there is no alternative supplier and therefore find it less 'expensive' to be conciliatory now than take the risk that at some point in the future the supplier's sense of inequity leads to either a breakdown of the relationship or the supplier exiting it! However, even a dominant customer might simply perceive that the inequity that its partner is suffering is morally unacceptable (Scheer, Kumar and Steenkamp 2003).

Where a supplier perceives there to be inequity between the ratios it is to be expected that they will pursue actions aimed at correcting that inequity (Adams 1965; Frazier 1983). Writers, such as Adams (1965), have set out measures that a party can implement to rectify a perception of inequity. These actions are complex in terms of both their interactions and the motivation behind them and thus further demonstrate the multiplexity (Aldrich and Whetton 1981) of on-going relationships.

These actions are for the suppler to:

1. Alter its outputs. The customer will have specified either in a formal contract or in a statement of "The Terms of Business" those aspects of the product (either goods and/or services) that it regards as critical. A supplier may seek to persuade a customer to change elements of this specification but, especially in cases where it is one of a number of competitors supplying the same item, this might not be negotiable. However, it is possible that there are aspects of the supplier's outputs which the customer does not regard as contentious and therefore it is possible for the supplier to change them. The challenge is to be sure that the customer's expectations are adequately understood as it is not unknown for customers to express irritation or worse when some aspect of a supplier's product, which is not specified in either the contract or the terms of business, is altered. Such behaviour on the customer's part may appear unreasonable to the supplier but may be the result of expectations based on the fact that "you've always done it this way"[7].

2. Alter its inputs. Any competent firm is constantly looking for ways in which to increase its efficiency without compromising the quality of the output that is expected by its customers. One way of doing this is to change its inputs. Moreover there can be cases where, by changing its inputs in a manner advantageous to itself, a supplier is able to alter its outputs in such a manner that the customers are offered an improved product. Blois (2003b) provides

[7] Courtaulds once nearly lost a contract with a major customer because it changed from packaging its textile products in wooden crates and delivered them in cardboard packs instead. The specific type of packing was not specified in the contract and the customer admitted that the cardboard packs were completely adequate but it had been making a useful income through selling the empty wooden crates.

an illustration of a firm that was able to reduce its own delivery costs (i.e. reducing its inputs) but simultaneously provide its customers with an improved service (i.e. improving its output)

3. Distort their inputs and outputs cognitively. This approach relates to Adams' view that it is perceptions that influence judgements of equity. It follows that if a firm re-evaluates its perception of either inputs or outputs then its view of the equitability of the situation will be changed. For example, regarding inputs, the firm may persuade itself that certain resources being used in the process of creating a product have no alternative uses and perhaps even that their disposal will incur costs. This could be the case where employees are one of the resources and making employees redundant may be an action with which substantial costs (both monetary and reputational) are associated. As Adams commented: "Whether or not an attribute having the potential of being an input is in fact an input is contingent upon the possessor's perception of its relevance to the exchange." (1965, p.277)

   With regard to outputs, a firm may come to recognize that dealing with a particular customer can bring with it some previously unrecognized advantages such as its technical advice that, while intangible, are of value.

4. Change the object of their comparison. A firm may regard it as inequitable that its customers are able to make higher profits than it does but it is arguable that the most obvious comparator should be its competitors not its customers. Even so should it only compare itself with those competitors that supply the same customers as it does? Moreover, even if it does decide to use one or more competitors as its comparator(s), there is the question of which to use. Given that the probability of finding a competitor that is similar in terms of: size; location; product range; or, any of the many factors which impact on a firm's profitability this is not a trivial issue. In fact it is very easy for a supplier to misunderstand the underlying economics of the firm with which it chooses to compare itself.

5. Act on the other party. It may be that the other party is unaware that an inequity is perceived and so the first move here must be to ensure that the other party is aware of the situation. In some cases making them aware may be sufficient to allow an open discussion of the issues and some renegotiation of the terms of the contract[8].

   In other cases it may be possible to persuade the customer that special circumstances exist which justify it acting in a manner which is advantageous to the supplier. Thus one of Ford's suppliers was able to use Ford's commitment to expand its support of minority suppliers to persuade Ford to give it a subsidy so that it could "achieve parity in production efficiency with their incumbent suppliers" (Narayanda and Rangan 2004, p.66)

As was pointed out above, the value of the ratios of inputs to outputs will vary over time but a party will not accept what they perceive to be an inequitable situation for a prolonged period. However, their pursuit of any of the five options outlined above will take time and during this time

[8] However this did not happen when Entertainment UK (a subsidiary of Woolworths UK) announced twelve months before the end of its three year contract to supply to supply £450 million of CD's and DVD's to Tesco that it would not seek to extend the contract (Finch 2006). The reason given was that Tesco, when negotiating the detailed terms of the final year of the existing contract, forced Entertainment UK into a loss-making situation. Woolworths stated: "We won't write business we don't think makes economic sense. We put forward a fair and reasonable proposal . . . but Tesco feel it is not economically sensible for them." It is estimated that the final year of the contract will result in Woolworths incurring a loss of at least £10million and its share price dropped 12% on the announcement of this problem.

the circumstances under which they are acting will be evolving and may include, for example, some action by the other party in an attempt to mollify the aggrieved party. It follows therefore that while at any moment in time a situation between buyer and seller may appear quite inequitable the seller may accept it because it is initiating actions which it believes will make the situation less inequitable in the future. Indeed, because at any point in time the market environment will be changing and the parties involved will be adjusting their responses to each other, the situation is always fluid and a supplier when deciding how to act has to make assumptions about the future nature of their relationship with the customer and also about the context within which that relationship will be existing.

The 'exit' option

There is one other option open to the aggrieved party and this is to 'exit' the relationship. This Adams calls a "fairly radical means of coping with inequity" (1965, p.292) but he suggests that the greater the inequity the more probable it is that this will be the action taken. If it 'exits' the supplier is saying it can utilise its resources in some other way which will enable it to achieve a more acceptable situation than by continuing its interaction with the existing customer. 'Other ways' could include many different policies including, for example, engaging with a new customer to supply the same or similar products; supplying a new range of products either to the existing customer(s) or new ones; closing the business[9]; etc.

Yet the 'exit' option is, given the specificity of modern organizations' resources (employees; knowledge; physical capabilities; reputation; etc.), not always realistic. The ability of many firms to make radical changes to their product range or to find substantial new customers is often quite limited. For example when Tesco cancelled its £60 million per annum contract with Dairy Crest (a British milk processor) for the supply of fresh milk Dairy Crest's profits were halved and redundancies were threatened (The Independent 11-11-05, p.69) because Dairy Crest was left with substantial excess capacity. Large customers are, of course, well aware of the likely impact on a supplier of the loss of an order and will use this knowledge when negotiating with them.

Some suppliers, by becoming reliant on the extensive technical support and market information provided by their large customers, have allowed themselves to become even more dependent upon their customers than the value of their sales might be suggest. Furthermore, some large customers have increased this dependence by making the continued placing of orders with a supplier dependent on that supplier not seeking orders from their competitors. Overall it is clear that, unless another customer that the supplier believes will provide a similar level of income can be found, then the supplier's ability to 'exit' can become, at best, constrained. In such circumstances 'exit' is not a real option from amongst the alternatives of 'exit, voice or loyalty' (Hirschmann 1970). This is illustrated by the case of Baird which was until 1999 one of Marks and Spencer's major suppliers. Approximately 40% of Baird's revenues came from sales to Marks and Spencer and in addition Baird had allowed itself to become increasingly dependent on Marks and Spencer for technical and market advice. Furthermore Marks and Spencer had forbidden Baird to be a supplier to its competitors. Baird's inability to use 'exit' as a strategy is indicated by the fact that, when Marks and Spencer informed Baird that it would no longer being using it as a supplier, Baird was unable to acquire another customer of Marks and Spencer's size and found it necessary to make 4,300 employees redundant (Blois 2003a).

As the case of Baird and Marks and Spencer illustrated, if it is assumed that a firm wishes to continue to exist, then 'exit' may not be a possibility and a firm may have no alternative but to

[9] An interesting example of this is the owner of a small business who decides that they can live more comfortably by closing their business and living off any proceeds. They recognize that they may have a lower income but will also face less financial uncertainty and less stress.

remain a supplier to their existing client - at least in the short-term. In such cases continuing as a supplier is not a demonstration of ‘loyalty’ - it is simply ‘a necessity’ that results from a “calculative commitment” (Kumar 2005, 863). This would seem to have been the case in 2000 when Chrysler in the US imposed a 5% price cut (to be followed by a further 10% reduction in the next twelve months) on its suppliers. At the time the US car industry had a large amount of spare capacity and the expectation was that this would be the case for several years so suppliers reluctantly accepted these imposed price cuts as the alternative was closure. As Beetham stated: “The awareness of their impotence outside the relationship can itself be sufficient to keep the dependent party submissive to the wishes of the superior, without any threats needing to be made.” (1991, p.45)

Summary

It has been proposed that examining relationships from the perspective of ‘equity’ would provide some potentially useful insights into why suppliers might continue to trade with large customers that appear to dominate them. It was suggested that such domination would initially only be problematic to a supplier when it felt that it was being treated inequitably but it was recognized that there are actions that a supplier can take to seek to rectify any perceived inequity. However, it was accepted that, given the specialised nature of modern organizations, there will be cases where an organization has no alternative but to continue to supply a dominant customer or go out of business no matter how inequitable the supplier believes the situation to be. Yet where a supplier perceives that such inequities do exist the interactions with the customer will remain unstable.

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