

Ensuring Intra- and Inter-Organizational Relationship Survival under Exogenous and Endogenous Shocks and Distress: The Role of Social Capital and Agent Aspiration Levels

By

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Problem Statement

In order to successfully exploit new profit opportunities entrepreneurial individuals and organizations are often forced to establish new intra- and inter-organizational relationships and network. These networks often include relationships with suppliers and consumers (i.e. economic clusters), but may also involve a group of like-minded producers combining their efforts to produce a product or service in hopes of obtaining economies of scale and market power.

When used to exploit entrepreneurial opportunities, these types of network relationships, like others, often lack financial capital. This is particularly true in the early stages of the venture. As such, intra- and inter-organizational relationships often fail during the early stages of development due to various endogenous and exogenous shocks related to unexpected market, and cash flow events.

In some case, however, these types of organizations are able to remain intact after such shocks even without additional financial capital injections or external mediation. Explanations of this organizational phenomenon are lacking. In particular, there has been little work on developing a consistent, analytical and conceptual framework that addresses this issue.

Objectives of Study

The objective of this paper is to introduce the concepts of social capital and adaptive-motivated behavior (March and Simon, 1958; Mahoney, 2005) to address this problem in a principal-agent framework. In particular, an analytical model is developed to explore the role of social capital and firm aspirations as governance and support mechanisms to ensure the enforcement and maintenance of these intra- and inter-organizational relationships during periods of shock. It is argued that social capital can be used as a substitute for financial capital in the short-term of the relationship and the partner aspiration levels serve to indicate a partner's willingness to join and stay within the organization or network over time.

Procedure

In the first section of this paper, we review the literature on the private enforcement of contracts and introduce the concepts of social capital and firm aspiration levels. Traditional contract enforcement literature suggests that at each time period, the parties to a contract perform a cost-benefit analysis of breaching the contract (Gow and Swinnen, 2001; Gow and Oliver, 2004; Oliver 2004). Typically, these models include an evaluation of the expected returns of the relationship against a reservation level for each

party. In times of financial hardship, these models often predict that relationships should dissolve as the discounted value of current and future contractual relationships contract and making contract breach optimal. However, these models have not explored the roles of social capital and aspiration levels in this analysis.

By introducing the adaptive-motivated behavior model (March & Simon, 1958), we suggest that the decision of a partner to leave a network is dependent on his/her satisfaction level within the network. The lower the satisfaction level of the partner, the more search for alternative opportunities the partner will undertake and the more likely it will reject the network relationship. Satisfaction levels increase with the realized and expected value of the returns from the network and decrease with the partner's aspiration level. In other words, intra- and inter- organizational relationships fail when the realized or expected returns of the relationship do not meet the aspiration levels of the partners. This situation may occur when: 1) unexpected negative market, and cash flow events occur, or 2) the aspiration levels of the business leader (i.e. entrepreneur)³ and the relationship partners are not aligned.

We further suggest that when shortfalls do occur, for either case, that these shortfalls can be mitigated by the business leader using his/her social capital to maintain the relationship. Social capital is the value given to a person's position in a structure of relationships and is closely related to their reputation and trustworthiness (Lin). By *spending* their social capital, business leaders can persuade partners to 'rideout' short-term poor performance and to align their aspiration levels with those of the business leader in the long-term.

In the second section of the paper, we step through the development of an analytical model that describes the mechanisms by which entrepreneurial networks can be established and self-enforced to create sustainable entrepreneurial producer organizations, marketing channels and networks. The model utilizes a traditional principal-agent framework in which a payoff function is defined along with the relevant constraining relationships which bound the decision feasibility region. Within this model the roles of social capital and adaptive-motivated behavior are emphasized.

The model described above is supported by empirical evidence from two case studies of entrepreneurial networks in the agri-food sector within a developed and developing country environment. The first case analyzes the establishment and transformation of Cellars of Canterbury (Gow and Oliver, 2003) over a decade. Specifically what was required to bring together five independently successful wineries to initially create a jointly owned domestic marketing entity, how were they able to leverage this to later expand internationally and finally why did these individuals shut down a successful operation. The second set of cases analyzes a network of private and cooperatively owned milk collection stations and micro processing enterprises in Armenia following independence. Specifically, the impact of different levels of business leadership, social

³ The business manager (i.e. entrepreneur) is assumed to have influence over the value of the expected returns of the relationship.

capital and individual and cooperative aspiration levels have upon the success or failure of an entrepreneurial enterprise.

Results

1. Business leaders with a high degree of social capital are better able maintain their inter-organizational relationships through unexpected market shocks and periods of short-term distress in financial capital and cash flows.
2. *Ceteris paribus*, partners with low aspiration levels will remain in a network longer through these shocks than partners with high aspiration levels.

Conclusion

1. The inclusion of social capital and partner aspiration levels serve to address why in the absence of adequate financial capital and cash flows, some entrepreneurial producer organizations and agri-food networks remain intact while most implode.
2. The social capital of the business leader is an important determinant of the success of an entrepreneurial venture.
3. Business leaders with a high degree of social capital are better able to ensure the stability and maintenance of intra- and inter-organizational relationships during unexpected market shocks and periods of short-term distress in financial capital and cash flows.
4. Future research may use simulation modeling to examine the conditions in which entrepreneurial networks facing distress can be sustained by social capital.

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