

# Why Incomplete Contracts Foster Innovation: A Transaction Cost Economics and Agency Theory Perspective

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## Why Innovation

- Highly dynamic business environments
- Large fluctuations in the economy
- Increased globalization

Organizations can engage in service innovation through inter-organizational relationships (IORs)

IORs often result in early termination, opportunistic behavior from the partner, loss of control for the organization, distrust and misunderstanding, while they do not result in the expected performance and innovation

## Use contracts to govern IORs

Contract theory

- Maximum protection from hazards and maximum gains from the transaction require organizations to design contracts as complete as possible

In reality, one observes contracts that are incomplete

- Bounded rationality
  - Balance the choice between ex-ante and ex-post costs
- Contracts may be incomplete even in cases of low transaction costs → purposeful

A relatively new contracting type which is suggested to foster innovation is the **performance-based contract (PBC)**

**So far, no guidance on how PBCs affect innovation**

**Goals:** (1) what are the dimensions of a PBC, (2) which contractual dimensions influence innovation, and (3) how PBCs lead to innovation

## Expected Results

- Integration of Transaction Cost Economics and Agency theory
- PBCs are characterized by two dimensions
  - **low term specificity**
    - Inverted U-shaped Relationship
  - **rewards linked to performance**
    - Linking rewards to performance attenuates the negative relationship between term specificity and innovation when term specificity is too low
    - The more a risk-averse a partner is, the less they will engage in innovative activities

## Managerial Contributions

- Further understanding of what influences innovation from a contractual perspective
- By focusing on value-based sourcing, thus incorporating contracts such as the PBC, instead of going for the lowest-cost strategies, organizations will enjoy the benefits of the experience and innovative capabilities of their partners
- Optimum level of term specificity that maximizes innovation

Effects of Low Term Specificity on Innovation

