**Routledge Encyclopedia of International Political Economy**
(Forthcoming)

# Entry for **Alliances (inter-firm)**

by Benjamin Gomes-Casseres

An inter-firm alliance is an organizational structure to govern an *incomplete contract* between *separate firms* and in which each firm has *limited control.* Because the partners remain separate firms, there is no automatic convergence in their interests and actions. As a result, to deal with unforeseen contingencies inherent in the incomplete contract, the partners need to make decisions jointly. (See Gomes-Casseres, 1996.)

A contract is termed incomplete when, despite the fine print, it does not specify fully what each party must do under every conceivable circumstance (Williamson, 1975; Hart & Holstrom, 1987). Lawyers generally try to avoid writing incomplete contracts, because these arrangements typically end up in court or in arbitration when an unforeseen controversy arises. Even so, legal experts would be the first to recognize that many contracts are incomplete in one way or another and that "evolving contracts" or "relational contracts" are needed to govern such agreements; these are essentially alliances (Williamson, 1979).

For many economists, the prevalence of incomplete contracts yields the basic rationale for the existence of the firm (Coase, 1937). Market transactions work well when the parties can write complete contracts, they argue. But when this is not possible, it is usually more efficient to "internalize" the transaction within a firm; this firm can then make optimal decisions when unforeseen circumstances arise. If such an incomplete contract is left to the market, the parties, each acting in its own best interest, are likely to haggle over how to handle the "gaps" in the agreement. At the extreme, the very prospect of such ex-post haggling and opportunistic behavior might deter the parties from concluding an agreement in the first place. Integration is thus many economists' favorite way of governing incomplete contracts

For example, the need for heavy investments in relationship-specific assets may lead to bilateral monopolies that create incentives for opportunistic recontracting. It is often impossible or costly to write contracts that avoid this problem. Knowing this, firms will likely decline to conduct such transactions through contracts, choosing vertical integration instead (Williamson, 1975).

An alliance is an alternative way to govern such an incomplete contract. Alliance agreements are typically open-ended and contain "gaps" typical of incomplete contracts. In contrast to full integration, alliances use some form of joint decision making to deal with unforeseen circumstances. Note that the designers of the alliance do not create these gaps on purpose—rather, they design the alliance to govern the incomplete agreement that stems from the nature of the business and the industry in which they are operating.

©Benjamin Gomes-Casseres 1999

Alliances thus involve a mix of features of firms and of markets (Stinchcombe, 1990). They resemble markets in that the partners remain separate parties, driven by their own interests. Each partner thus runs some risk that the other will act opportunistically, as traders might in the open market. Alliances resemble firms in that the partners agree to coordinate their actions and participate in joint decision making. In this sense, the partners practice mutual forbearance: they forgo short-run opportunistic actions in the interest of maintaining the relationship, which they expect will yield long-run benefits (Buckley & Casson, 1988). Like firms, alliances involve some degree of "trust" between transacting parties.

Although all alliances share these basic attributes, they come in a myriad of different structural forms. These different structures affect the pattern of decision making and the control of capabilities. Jointly owned ventures, licensing relationships, joint R&D programs, co-marketing programs, and partial equity investments are all alliances by this definition. The relationship between a buyer and supplier of an intermediate product, too, may represent an alliance, provided that the contract between the two is in some substantial sense incomplete.

Alliances also differ according to the operational relationship between the partners. Some alliances represent what economists call "vertical" relationships (i.e., between suppliers and buyers) and other represent "horizontal" relationships (i.e., between companies selling the same or similar products). Some alliances combine one firm's technological capabilities with another firm's marketing organization; other alliances pool similar capabilities from different companies.

The differences between these alliance forms and motivations can be the subject for a more extensive discussion (see Kogut, 1988 on various approaches to alliances and Hennart, 1988 on the role of equity). These differences do matter for many purposes, but because the various alliance forms share many behavioral characteristics, they can often be grouped together for analytical purposes.

Regardless of the form, three conditions must obtain for an alliance to be an optimal form of organization, or what economists call "efficient." First, there must be an advantage to combining the capabilities of two or more firms. For this to occur, each firm must be unable to develop internally the capability offered by the other firm; for example, it may be constrained in doing so by its resources, by its skills, or by time. Also, the combination of capabilities must yield a total value that is greater than if the capabilities were used separately. This type of "synergy" is common in modern businesses.

The second condition required for an efficient alliance is that it be costly or impossible to combine the capabilities through pure market transactions (i.e., using complete contracts). For example, each owner may need to "tailor" or upgrade its capability through investments or invisible efforts that are specific to the transaction; this creates a threat that one firm will hold the other "hostage" after the investment is made, and try to extract a greater share of joint profits. Complete contracts under such circumstances are costly to

©Benjamin Gomes-Casseres 1999

negotiate, monitor, and enforce, as each firm will have an incentive to cheat. The firms then have to find an alternative way to govern the incomplete contracts that result.

Complete ownership would be a way to govern such incomplete contracts. So, the third, and final, condition for a constellation to be optimal is that a full merger between the firms must be costlier than a series of alliances as a way to govern the incomplete contracts. This condition does not occur as commonly as the other two, with the result that we often see full integration as a mechanism for combining capabilities. But when there are limits to the size and complexity of the fir (i.e., when integration generates high costs) then an alliance is a more efficient solution. Alternatively, there may be regulatory or political barriers that preclude full integration and drive firms to an alliance as a "second-best" solution.

A recent stream of research in inter-firm alliances focuses not on the bilateral governance of these relationships, but on how a series of interconnected alliances create "networks" (Gulati, 1998) or rival "constellations" (Gomes-Casseres, 1996). In this latter view, alliances are seen as creating new units of competition and reshaping rivalry—instead of firm against firm, the new rivalry is one of group against group. Constellations of allied firms are thus seen as an alternative to the firm in governing a set of complementary capabilities.

## References

Buckley, Peter J. and Mark Casson, "A Theory of Cooperation in International Business," in *Cooperative Strategies in International Business,* ed. Farok J. Contractor and Peter Lorange (Lexington, Mass.: D. C. Heath, 1988).

Gomes-Casseres, Benjamin. *The Alliance Revolution: The New Shape of Business Rivalry* (Cambridge, Mass.: Harvard University Press, 1996).

Gulati, Ranjay, "Alliances and Networks," *Strategic Management Journal*, Vol. 19 (1998), pp. 293-317.
Coase, Ronald H., "The Nature of the Firm," *Economica* (November 1937): 386-405.

Hart, Oliver and Bengt Holmström, "The Theory of Contracts," in *Advances in Economic Theory: Fifth World Congress,* ed. Truman F. Bewley (Cambridge: Cambridge University Press, 1987).

Hennart, Jean-Francois, "A Transaction Costs Theory of Equity Joint Ventures," *Strategic Management Journal* (July-August 1988).

Kogut, Bruce, "Joint Ventures: Theoretical and Empirical Perspectives," *Strategic Management Journal* (July-August 1988).

Stinchcombe, Arthur, "Organizing Information Outside the Firm: Contracts as Hierarchical Documents," in *Information and Organizations,* ed. Stinchcombe (Berkeley: University of California Press, 1990).

Williamson, Oliver E. *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press, 1975).

Williamson, Oliver E. "Transaction-Cost Economics: The Governance of Contractual Relations," *Journal of Law and Economics* 22 (October 1979): 23-261.

©Benjamin Gomes-Casseres 1999