Abstract:

Recent empirical findings point at the actual use of formal contracts by business parties alongside substantial elements of their dealings remaining informal, and thus subject only to reputational or other reciprocity-based consequences. In this paper we formally show the supporting role of formal contracts of relational contracts. Even entirely disregarding contract enforcement through a Court or arbitrator, we formally show that such formal (yet non-enforceable) contracts may have an important and positive influence over the reputational or reciprocity-based sanctions that firms may impose upon their suppliers in order to sustain cooperation in relational contracts. We demonstrate that setting compliance with certain tasks in a formal contract reduces the cost of reputational punishments than firms may need to in inflict in order to ensure the right incentives to provide effort. We also show that formal contracts impact the way in which reputational punishments will be structured: Formal contracts optimally induce a more eschewed pattern of sanctioning, compared to a benchmark case in which no formal contract has been agreed. Thus, when dealing with its counterparties a firm will be, when the relational contract comes together with a formal contract, less forgiving with those counterparties who have not performed the formal contract, and more forgiving with those other ones who have not infringed the provisions of the formal contract.