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## Antecedents of contractual completeness: the case of tour operator-hotel allotment contracts

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### Abstract

This study aims to explain completeness of contracts by using and extending the transaction cost theory. First, we investigate the impact of transaction characteristics (i.e. environmental uncertainty and specific investments) on contractual completeness. In addition the study extends the transaction cost view by investigating the moderating effect of trust on the relationship between transaction characteristics and contractual completeness within the context of transaction cost theory. We offer a completeness scale consisting of contingency planning in hotel allotment contracts. Our results from Turkish tourism industry support the transaction cost hypotheses and the moderating effect of trust on the relationships between transaction cost variables and completeness of contracts. This study extends the transaction cost literature on contractual completeness by showing that trust functions as moderator between the transaction cost variables and contractual completeness.

*Keywords:* Contractual completeness, Uncertainty, Specific investments, Trust, Transaction cost theory

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## 1. Introduction

The aim of this study is to examine the impact of transaction characteristics including environmental uncertainty and transaction-specific investments and trust on the degree of contractual completeness in the tourism industry. For this purpose we develop a conceptual framework to explore the completeness of hotel allotment contracts in the Turkish tourism industry (Figure 1). According to the theoretical model, we anticipate that transaction characteristics have negative effects on the degree of contractual completeness when they lead to problems of appropriation and adaptation. In addition, we extend the transaction cost perspective by analyzing the impact of trust on the degree of contractual completeness. Interorganizational trust reduces relational risk and increases information exchange thereby changing the costs of designing more complete contracts arising from appropriation and adaptation problems. Therefore we expect that trust moderates the relationships between transaction characteristics and contractual completeness. We empirically test the hypotheses using the data from the hotels in the Turkish tourism industry. The data support the transaction cost hypotheses and the moderator effects of trust on the degree of contractual completeness.

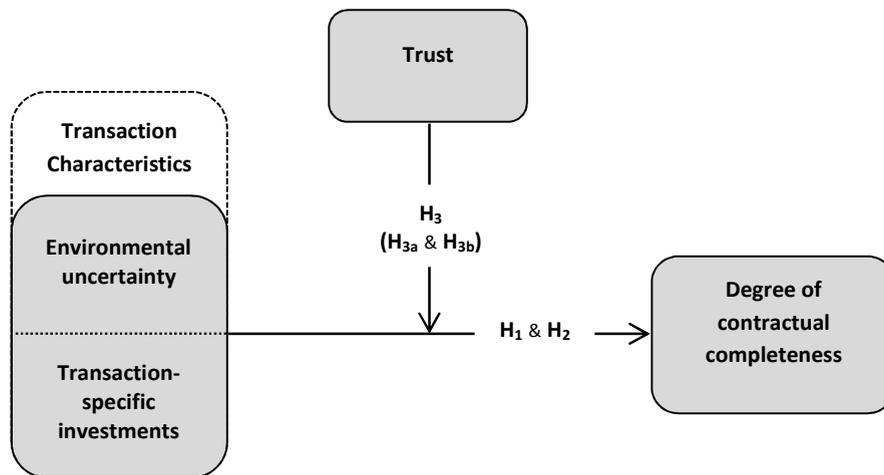


Fig 1. Theoretical model

In this paper we extend the transaction cost approach to explain contractual completeness. Specifically, the effects of transaction characteristics moderated by trust on the degree of contractual completeness are analyzed. In the existing literature empirical research on contracts is constrained by the difficulty to gather information on contract clauses. This study allows us to determine the provisions regarding contingency planning of contracts by applying a document analysis of hotel allotment contracts.

The paper proceeds in the following way. First, we review the literature regarding contractual completeness. Second, we develop hypotheses concerning the impact of transaction characteristics on completeness and discuss the moderating effect of trust on the relationships between transaction characteristics and contractual completeness. Third, we explain the data collection method and analytical procedures in detail. Next, we test our hypotheses with hierarchical multivariate regression. Finally, we provide the research findings and discuss their implications.

## **2. The Concept of Contractual Completeness**

According to Grossman and Hart (1986) [1] incomplete contracts result from cognitive boundaries and high costs of writing contracts. A contract which only specifies who has the right to decide and does not specify the decision actions when a certain contingency arises is incomplete. In actual contracts some contractual clauses regarding decision actions are specified, while the remaining contingencies are covered by formulating residual rights (or decision procedures) [2]. According to the incomplete contract theory and transaction cost theory, the contract design as incentive intensity and adaptation device differs in its capability to specify decision rights and actions [3], [4], [5]. The greater incentive intensity is to mitigate the risks of opportunism [6], [7] and the problems of performance measurement [8], [9], [10] and thereby to promote efficient adaptation. Contracts serve as safeguard mechanisms [11] by assigning decision rights (i.e. enforcing rights and monitoring rights) or contractual hostages that govern the problem of appropriation concerns. Beyond incentive intensity contracts may be an adaptation mechanism by assigning decision rights that govern the actions of exchange parties in their adaptation to unforeseen circumstances. Contingency planning involving anticipating and making provisions for problems during the contract execution period decreases the risk regarding complex tasks and appropriability of intellectual properties of the parties [12]. The contracts specifying contingences encourage coordination of the actions in interdependent tasks. The gains from designing a more complete contract are constrained by increasing costs of ex ante design. Thus, contracting parties have to balance the cost-risk tradeoff between the costs of drafting a more complete contract and the risks of incomplete agreements [7], [13].

Although the existing literature concentrates on the explanation of the degree of contractual completeness from the different theoretical foundations, there is still no consensus on its dimensions [14]. Recently, contractual completeness has been investigated in the organizational economics and strategic management literature. Luo (2002) [15] defines the dimensions of complete contract as term specificity and contingency adaptability and examines the main effects of them on performance. In a further study, Luo (2005) [16] investigates an additional dimension of contractual completeness, i.e., contract obligatoriness, and explores the effects of institutional environment and investment characteristics on the three dimensions of contractual completeness by applying transaction costs and property rights reasoning. Anderson and Dekker (2005) [17] investigate the question if the costs of writing an agreement vary with the extensiveness of the contract. On the other hand, strategic management literature focuses on the evolution of contract design capabilities through interorganizational learning [18], [19], [10]. Argyres and Mayer (2007) [18] suggest that higher contract design capabilities increase contractual completeness. Contractual design capabilities will evolve by learning to manage the trade-offs between different types of contractual provisions [20]. Due to the variety of contractual dimensions used in organizational economics and strategic management research, Furlotti (2007) [14] criticizes the concept of completeness used in empirical studies and offers a multi-dimensional construct which captures multiple functions affecting adaptation requirements of bounded rational actors.

### 3. Hypotheses

#### 3.1. Transaction Cost Hypotheses

According to the transaction cost theory [3], [21] bounded rationality limits economic agents to write complete contracts. Due to cognitive boundaries of contract partners and high transaction costs all complex contracts are incomplete. The comparative costs of contract design invoke the discriminating alignment [22] with transaction characteristics, such as environmental uncertainty and transaction-specific investments. The higher the environmental uncertainty, the higher the ex ante and ex post transaction costs under preplanning of decision actions, and the lower is the degree of contractual completeness. In consistent with Saussier (2000) [13] marginal cost of one more incremental contingent claim will be more than its marginal utility in a higher uncertain environment whereas the contract is more complete.

H<sub>1</sub>: Environmental uncertainty is negatively related with the contractual completeness.

Transaction-specific investments also influence the contract design. If an economic agent makes transaction-specific investments, the risk of opportunism increases with the threat of terminating the relationship or breaking the commitments. The renegotiation costs induced by incentives for opportunistic behavior can be economized by designing a more complete contract. Therefore, in the hotel-tour operator relationship the hotels want to protect their transaction-specific investments against opportunism by using more specified contracts. However, the tour operators have a strong bargaining power to influence the contract design and to set up more incomplete contracts in order to maintain adaptability in a changing business environment. Accordingly we formulate the following hypothesis:

H<sub>2</sub>: Transaction-specific investments are negatively related with the contractual completeness.

#### 3.2. Trust Hypotheses

In addition to the influence of environmental uncertainty and transaction-specific investments trust may influence contractual completeness. Specifically, trust moderates the effect of transaction characteristics on contractual completeness offered by the transaction cost theory. According to Williamson (1991) [5] trust is a shift parameter to mitigate opportunism risks through controlling opportunism and enhancing the capacity to process information. In addition by improving information sharing between the contract partners trust economizes on bounded rationality and shifts the comparative costs of contract design [23].

(a) Environmental uncertainty and trust: Trust reduces the negative impact of uncertainty on contractual completeness because it increases information exchange between the partners thereby enabling the contract partners to set up more specified contracts. This effect is stronger under high trust than under low trust.

(b) Transaction-specific investments and trust: The contract partners (i.e. hotels) who have invested in a relationship under a small number of potential partners (i.e. tour operators) will be vulnerable in uncertain business environments even if the both parties make transaction-specific investments. This is due to the fact that the hold-up risk due to asymmetric investments may not damage both parties equally in a unilaterally dependent relationship under high uncertainty. However, when trust exists between the partners, the stronger partner (i.e. tour operator) is more motivated to set up a contract design with more provisions that protect the hotel partner's specific investments. In this case, trust reduces the risk of unfair quasi-rent allocation. As a result we formulate the following hypotheses:

H<sub>3</sub>: Trust has a moderating effect between transaction characteristics and contractual completeness.

H<sub>3a</sub>: The negative impact of environmental uncertainty on contractual completeness is lower under a higher level of trust.

H<sub>3b</sub>: The negative impact of transaction-specific investments on contractual completeness is lower under a higher level of trust.

#### 4. Research Methodology

##### 4.1. Data Collection and Sample

In this study qualitative and quantitative methods were used to collect the data. The major method of the qualitative data was a document analysis of allotment contracts between tour operators and hoteliers. The contract provisions in a number of nonguaranteed allotment contracts were compared and contingent adaptability terms in non-standard and unprinted form were selected to develop the scale of contractual completeness. The interviews with a group of general managers or sales managers of hotels located in Antalya/Turkey were used to have a better understanding of contract content. The data collected through the document analysis and interviews were content-analyzed; they determine the items for contingency planning in the contractual completeness scale. In the second step a quantitative study was conducted through a questionnaire based survey.

The empirical data to test the theoretical model and hypotheses were collected through an e-mail survey targeting first class holiday villages, five stars hotels and four stars hotels in Antalya. There are 468 hotels according to the accommodation statistics of the Republic of Turkey Ministry of Culture and Tourism, 2010 [24]. Sample size was found about 270 hotels after the calculation for a 95% confidence level, 5% margin of error with a response rate of 60%. The hotels in sample were selected with using epsem sampling procedures. A total of 141 completed questionnaires were received. The effective response rate is 52%. The data were analyzed with using SPSS (18.0) package program.

The respondents answered the questions regarding a relationship of a particular tour operator who has the highest sales volume in the high season. The constructs of contractual completeness, environmental uncertainty, asset specificity and trust were used with the control variables of origin of the tour operator, bargaining power and conflict resolution in the survey. We examined the potential for response bias by comparing early versus late responses on measures regarding conceptual constructs and control variables. The test of multivariate analysis of variance (MANOVA) shows no significant differences for the measures between early and late respondents (Wilk's Lambda = 0.92, F = 1.72, p = 0.11). In addition, we examined the possibility of common method variance. To test this, Harman's single factor test [25] where all variables are hypothesized to load on a single factor was performed using exploratory factor analytic approach [26], [27]. The results of the unrotated factor solution of the 16-items reveal that the first factor does not account for the majority of the variance (35%) and there is no general factor.

##### 4.2. Measurement and Validity

The variables were measured by using multi-item scales (Table 1). The overall scale consists of items measuring the contractual completeness (8 items), environmental uncertainty (2 items), transaction-specific investments (3 items) and trust (3 items). For this study, contract design is considered as a legal bond which accounts for a set of future contingent claims. The degree of completeness of hotel allotment contracts is defined by its capacity to determine future contingencies by establishing adjustment and

conflict resolution procedures. To operationalize the degree of completeness for a special type of contracts in the service industry the contract clauses in a number of nonguaranteed allotment contracts were compared and contingent claims in the form of unprinted and non-standard clauses [17] were collected to develop the scale.

Environmental uncertainty was measured in terms of unpredictability. A two-item scale, developed from the interviews, was used to measure the construct. These are predictability of general tourism demand and hotel occupancy rate. The respondents assessed how predictable each of the items has been during the past 3 years and the items were measured by Likert-type scale. The other transaction characteristic, transaction-specific investments, refers to the investments on electronic information and reservation systems to coordinate the operations and the other resources and facilities to fulfill service standards and requirements dedicated to the relationship. According to our interviews a three-item scale was developed to assess the construct. In addition a three-item scale, adapted from Carson et al. (2006) [28], was used to measure trust.

We conducted exploratory factor analysis with varimax rotation to check the validity of the constructs. The Kaiser-Meyer-Olkin (KMO) measure of sampling adequacy is 0.74 and the Bartlett test of sphericity is highly significant (Bartlett's Test: 1228.28;  $p = 0.00$ ), indicating that the data are suitable for factor analysis. The exploratory factor analysis yields a four-factor solution accounting for 70 percent of the cumulative variance. According to the Kaiser rule [29] the factors are retained with eigenvalues greater than 1. Factor loadings of the 16 items are above 0.50 [30], ranging from 0.64 to 0.89. The Cronbach's alpha values of each construct are over 0.70 except 0.58 for environmental uncertainty. By testing the construct validity the reliabilities above 0.50 [31], [32] provide the evidence of internal consistency for each construct.

Table 1. Reliability and construct validity

	Cronbach $\alpha$	Factor loading			
		F1	F2	F3	F4
<i>F1. Contractual completeness</i>	0.90				
The contract stipulates all aspects concerning the stop sale conditions, release periods and reciprocal liabilities regarding these.		0.68			
The contract stipulates all aspects concerning in which circumstances the guest complaints are reasonable to subject penalties.		0.73			
The contract stipulates all aspects concerning the penalties for reservation cancellations exceeding the release period and no shows.		0.86			
The contract stipulates all aspects concerning enforcement and liabilities of this tour operator's payment terms.		0.64			
The contract includes the enforcement to be implemented if this tour operator can not sell its allotment.		0.74			
The contract stipulates all aspects concerning the exemptions of the liabilities of the hotel in case of force majeure until the situation ends.		0.80			
The agreement includes the liabilities of both parties equally.		0.72			
The contract stipulates all aspects concerning the solutions of the disputes arising from the agreement.		0.81			
<i>F2. Environmental uncertainty</i>	0.58				
The predictability of general tourism demand.			0.76		
The predictability of hotel occupancy rate.			0.83		
<i>F3. Transaction-specific investments</i>	0.86				
We made substantial investments in our facilities in order to provide the requirements of this tour operator.				0.89	
We spend a lot of efforts and resources to meet this tour operator's requirements for our service standards.				0.88	
We spend a lot of time and resources (i.e. electronic information and reservation systems) to coordinate the operations with this tour operator.				0.81	
<i>F4. Trust</i>	0.73				
The conflicts would be resolved fairly, even if no guidelines stated in our formal agreements.					0.89
When an unexpected situation arose, the parties had a mutual understanding that a win-win solution would be found, even if it contradicted our formal agreements.					0.88
Both parties understood that problems arising during the relationship would be solved jointly through communication and cooperation rather than just referring to our formal agreements.					0.79

### 4.3. Control Variables

Three control variables, origin of the tour operator (Orig), bargaining power (Br\_pw) and conflict resolution (Cn\_res), which might influence the dependent variable, were incorporated in the model. We consider the effect of bargaining power on contract design. When a partner's bargaining position is relatively low, interest conflicts are likely resolved in favor of the powerful partner who has more decision and control rights in the processes of bargaining and negotiation of contractual clauses [33], [34], [35]. As the European travel industry is increasingly being concentrated by the leading tour operators, entry barriers to alternative members of distribution channels increases the dependence of hotels. However they can balance their dependence on tour operators by influencing the customers' preferences and repeated customer rate. Hotels with strong brand names have relatively high bargaining power during the negotiation process of contracts. As a result, we assert that hoteliers with higher bargaining power can design more complete contracts. Bargaining power was measured by using a 7-point Likert scale indicating the bargaining position of hoteliers in the negotiation and contract design process.

Origin of the tour operator in a particular relationship refers to the country generating tourism demand by tour operators. The categories of tour operators were analyzed whether there is a difference between the groups regarding the degree of contractual completeness. The result of Anova test shows that there is a significant difference among the tour operator groups ( $F=8.07$ ;  $p<0.01$ ). Tukey's post hoc comparisons of the groups indicate that German contracts are significantly more incomplete than the others. Then we used a dummy variable which equals 0 if the origin of tour operators is not in a German travel group and 1 if it is in a German travel group. The second dummy variable of conflict resolution is conducted with the tendencies of hoteliers to handle conflict of interests: 0 indicates resolution without court and 1 court resolution if necessary.

## 5. Results

Table 2 reports the descriptive statistics and Pearson correlation coefficients for all variables. The results show that the transactional variables and the control variable of origin of tour operators (Orig) are negatively correlated with the degree of contractual completeness (Comp). The construct of trust is positively correlated with Comp. Bargaining power (Br\_pw) and conflict resolution (Cn\_res) has also positive correlation with Comp.

Table 2. Descriptive statistics and correlations (N = 141)

Variables	Mean	S.D.	1	2	3	4	5	6	7
1. Comp	5.60	1.37	1.000						
2. EU	2.24	0.80	-0.219**	1.000					
3. TSI	3.61	1.55	-0.264**	-0.038	1.000				
4. Trust	6.01	0.96	0.330**	-0.214*	-0.260**	1.000			
5. Org	0.52	0.50	-0.355**	-0.060	0.131	-0.187*	1.000		
6. Br_pw	5.16	1.47	0.330**	-0.260**	-0.135	0.265**	-0.198*	1.000	
7. Cn_res	0.04	0.20	0.130	0.047	0.159	-0.175*	0.133	-0.142	1.000

\* $p < 0.05$  \*\* $p < 0.01$  (two-tailed)

To test our hypotheses, we estimated the following regression models:

$$\text{Comp} = \alpha_0 - \beta_1 \text{Orig} + \beta_2 \text{Br\_pw} + \beta_3 \text{Cn\_res} + \varepsilon_1 \quad (1)$$

$$\text{Comp} = \alpha_0 - \beta_1 \text{Orig} + \beta_2 \text{Br\_pw} + \beta_3 \text{Cn\_res} - \beta_4 \text{EU} - \beta_5 \text{TSI} + \varepsilon_2 \quad (2)$$

$$\text{Comp} = \alpha_0 - \beta_1 \text{Orig} + \beta_2 \text{Br\_pw} + \beta_3 \text{Cn\_res} - \beta_4 \text{EU} - \beta_5 \text{TSI} + \beta_6 \text{Trust*EU} + \beta_7 \text{Trust*TSI} + \varepsilon_3 \quad (3)$$

To test the hypotheses each set of variables were included in the model block by block for testing the exploratory power of treatments. Equation (1) captures control variables including Orig, Br\_pw and Cn\_res. Equation (2) is a function of control variables and direct effects of transaction characteristics. Finally, equation (3) estimates the overall model as a function of control variables, direct effects and interaction effects of trust. In this model the largest variance inflation factor as an indicator of probable multicollinearity is 1.12, well below the 10.0 cutoff [36]. Thus there is unlikely a multicollinearity problem.

Results of hierarchical moderated regression approach to test the hypotheses are summarized in Table 3. As shown in Model 2, we found significant negative relationships between EU and Comp ( $\beta = -0.203$ ,  $p < 0.01$ ) and TSI and Comp ( $\beta = -0.240$ ,  $p < 0.01$ ). These results provide support to H<sub>1</sub> which predicts that under bounded rationality and uncertain business environment designing a more complete contract is more costly than its potential savings due to reduced opportunism risk. In addition, they provide support for H<sub>2</sub> which predicts that hotels' transaction-specific investments are negatively related with the degree of Comp because conflicts of interest can be more easily and less costly solved in favor of tour operators during the contract period when the contracts are less specified.

In the third block of variable set the interaction effects between trust and EU and between trust and TSI were examined. The results indicate that both interaction effects are positive and significant. Therefore we provide support for the moderating effect of trust on the relationship between transaction characteristics and contractual completeness. First, trust shifts the costs of more complete contract design under environmental uncertainty by reducing relational risk and increasing information sharing. Accordingly, the negative impact of EU on Comp is lower under a higher level of trust, based on H<sub>3a</sub> ( $\beta = 1.850$ ,  $p < 0.01$ ). Second, trust reduces the risk of tour operators' inflexibility of more specified contracts for protecting the hotels' transaction-specific investments ( $\beta = 0.808$ ,  $p < 0.05$ ) in unilateral relationships; hence H<sub>3b</sub> is supported.

Table 3. The hypotheses tests with hierarchical multivariate regression (N = 141)<sup>†</sup>

	Contractual Completeness		
	Model 1	Model 2	Model 3
<b>Control Variables</b>			
Origin of the tour operator	-0.325**	-0.326**	-0.284**
Bargaining power	0.296**	0.216**	0.225**
Conflict resolution	0.215**	0.252**	0.288**
<b>Independent Variables</b>			
Environmental uncertainty (EU)		-0.203**	-2.010**
Transaction-specific investments (TSI)		-0.240**	-1.036**
Trust			-0.928**
Trust x EU			1.850**
Trust x TSI			0.808*
Model F	14.472**	13.131**	12.000**
R <sup>2</sup>	0.241	0.327	0.421
Adjusted R <sup>2</sup>	0.224	0.302	0.386

\* p &lt; 0.05 \*\* p &lt; 0.01

<sup>†</sup> Standardized regression coefficients are reported.

Regarding the control variables we found a significant negative relationship between Orig and Comp ( $\beta = -0.284$ ,  $p < 0.01$ ). The result shows that the contracts between hotels and tour operators from German travel chains have been designed less complete. This may indicate that German tour operators may have a stronger influence on the contract design due to their market power. When the hoteliers have the possibility to recourse to courts in resolving conflicts of interest, contracts are more specified; this is consistent with the positive relationship between Cn\_res and Comp ( $\beta = 0.288$ ,  $p < 0.01$ ). Finally, the higher the bargaining power of hoteliers on specifying contractual rights the higher is the degree of contractual completeness ( $\beta = 0.225$ ,  $p < 0.01$ ).

## 6. Conclusion

Contract design functions as a governance device to solve adaptability and incentive intensity problems due to transaction hazards. This study has examined the impact of transaction costs variables (i.e. environmental uncertainty and transaction-specific investments) and trust on the completeness of hotel allotment contracts in the Turkish tourism industry. First, we found that the transaction characteristics (i.e. environmental uncertainty and specific investments) have a negative effect on contractual completeness. Second, we found that trust moderates the impact of transaction cost variables on contractual completeness. Specifically, our research findings regarding the design of hotel allotment contracts can be summarized as follows:

- The unpredictability of tourism demand makes the design of more specified hotel allotment contracts difficult.

- When the hotels make high transaction-specific investments and the tour operators have high bargaining power, the hotels are strongly dependent to the tour operators. In this situation, the tour operators set up less complete contracts to increase the flexibility to adapt the changing environmental circumstances.
- As the level of trust between hotels and tour operators increases, the negative effect of environmental uncertainty and transaction-specific investments on contractual completeness decreases because trust increases information sharing and the cooperative behavior between the contract partners.

Overall, this study extends the transaction cost view on contractual completeness by investigating the impact of trust on contractual completeness. Specifically, we add the moderating effect of trust on the relationship between transaction characteristics and contractual completeness. It is expected that this paper will make a contribution to the existing literature by explaining the contract design between hotels and tour operators from the adaptability view of transaction cost theory. A tentative meaning of the study for the practitioners is that tour operators and hotels might write more specified contracts when the negative impact of exchange hazards on the contract design may be weakened by a high level of trust.

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