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Non-contractible investments and vertical integration in the Mexican footwear industry

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Abstract

This paper examines patterns of integration among manufacturers and retailers, using data from a survey of footwear manufacturers in Mexico. The property rights framework, developed in papers by Grossman and Hart [1986, J. Polit. Econ. 94: 691] and Hart and Moore [1990, J. Polit. Econ. 98: 1119], is differentiated from the standard empirical transactions cost framework. In the context of this industry, the most relevant distinction between the two frameworks is that the property rights framework addresses both the benefits and costs of integration, while the transactions cost framework focuses only on variation in the benefits of integration. We show that the costs of integration are highest where the retailer's non-contractible investment has an important effect on the overall profits from the relationship. Consistent with the property rights framework, the data suggest that integration is less likely in these circumstances. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

Transactions cost economics posits that a firm's decision to make or buy a part

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or service is affected by the presence of relationship-specific investments. Vertical integration (making) reduces the risk of hold-up once relationship-specific investments are sunk. The power of this idea, pioneered by Klein et al. (1978) and Williamson (1979) has been demonstrated by an extensive empirical literature.[1] This empirical literature has shown that the benefits of integration increase in the presence of relationship-specific investments. Grossman and Hart (1986) and Hart and Moore (1990) provide a formal model which explicitly considers the costs and benefits of vertical integration. Integration is seen simultaneously to alleviate and to create hold-up risks. Efficient ownership depends not only on the degree of relationship specificity of investments, but also on the importance of those investments in determining the profits of the trading relationship.[2]

Grossman/Hart and Hart/Moore have received considerable attention in the literature, and numerous theoretical refinements have recently appeared.[3] But 9 years after the formal model was published, Hart reported ‘‘Unfortunately, there has to date been no formal test of the property rights approach . . . ’’ (Hart, 1995, p. 49).[4] This paper attempts to address this gap by providing a test of the property rights model using data on manufacturer-retailer integration in the Mexican footwear industry.

Asset ownership in the property rights framework is driven by the need to balance incentives for non-contractible investments made by two managers. If one manager’s investment has a greater impact on the gains from trade or is more

[1] The empirical literature is surveyed by Joskow (1988) and Shelanski and Klein (1995). Early support for the link between specific investments and integration found in studies of the automobile industry (Monteverde and Teece, 1982), the aerospace industry (Masten, 1984), the electronic components industry (Anderson and Schmittlen, 1984) and the electric power industry (Joskow, 1987) have been confirmed in numerous more recent empirical tests.

[2] In recent papers, Whinston (2000, 2001) compares the transactions cost and property rights frameworks. He independently reaches some of the same conclusions addressed in this paper. In particular, he points out that predicted patterns of integration in the transactions cost framework depend upon the level of specificity while integration depends upon marginal specificity. He also shows that increased specificity may be associated with less integration because specificity can increase the costs as well as the benefits of integration. He then shows that existing empirical research on transactions cost does provide evidence on property rights. Whinston also considers the effect of the buyer’s investment level on the seller’s returns, and vice versa. That effect is assumed away by Grossman and Hart and is ignored in this paper.

[3] Recent extensions include Nöldeke and Schmidt (1995), Aghion et al. (1994), Garvey (1995), and Halonen (1997).

[4] One exception is Hanson (1995), who uses aggregate data from the Mexican garment industry to test a version of the Grossman and Hart model incorporating risk. More recently, Baker and Hubbard (2000) find that independent ownership of long-haul trucks in the US decreased following technological changes allowing greater contracting scope. Shelanski and Klein (1995) provide no references to tests of the property rights framework.

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