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# Asset specificity and the fear of exploitation

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**Abstract**

If asset specificity renders the investing party dependent ex post, why would the ex ante willingness to make relationship-specific investments vary? We show how specific investments generate both positive and counter-negative cooperative incentives. We also observe the influences of trust and time horizon on these incentives, which are aggregated to derive the specific investments effect (SIE). Our result suggests that while the fear of exploitation increases proportionally to the magnitude of specific investments and the attendant quasi-rents, it grows exponentially with the deterioration of inter-personal (trust) and/or inter-temporal (time horizon) contexts.


*JEL classification:* L14; L22

*Keywords:* Asset specificity; Fear of exploitation; Trust; Time horizon

## 1. Introduction

A central tenet of transaction cost analysis is that transaction-specific investments promote integration since the probability of opportunism to appropriate quasi-rents increases with investments highly specialized to an exchange (Williamson, 1985; Joskow, 1988; Anderson and Weitz, 1992; Gulati et al., 1994). As a classic example, the Chrysler Corporation in 1986 instructed its parts suppliers to reduce prices by 2.5 percent after specialized

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investments had been made. Chrysler strictly enforced this policy and terminated its relationships with suppliers who did not comply (The Next Act, 1986).

An interesting question arises: if asset specificity renders the investing party dependent and hence vulnerable to exploitation ex post, why would one's willingness to commit vary ex ante? Research shows that firms in Japanese automaking, Italian knitwear, and New York apparel industries demonstrate greater willingness than others to make specific investments (e.g., Sako and Helper, 1998; Dyer 1996; Uzzi, 1997). For example, Japanese automobile suppliers develop more unique parts for their customers and make greater investments in specialized assets. In contrast, components that require considerable engineering development efforts tend to be produced in-house in the U.S. (Smitka, 1991; Dyer and Ouchi, 1993; Monteverde and Teece, 1982). In a large-sample, cross-national empirical test, Dyer and Chu found that U.S. supplier-automaker relationships were characterized by lower asset specificity compared to Japanese relationships. The observed variation of institutional arrangement for transactions with specific investments suggests that the connection between asset specificity and governance structure may be more complex than has been explained by transaction cost economics (Robins, 1987; Chiles and McMakin, 1996; Nooteboom et al., 1997).

This paper offers an analytical approach that systematically explores factors that explain the variance of ex ante willingness to make specific investments. We argue that such variance depends critically on the extent to which specific investments create dependence upon making specific investments. Understanding the mechanisms of how specific investments create dependence is important because dependence gives rise to the fear of exploitation and diminishes the willingness to invest (Williamson, 1985; Anderson and Weitz, 1992; Morgan and Hunt, 1994; Gulati et al., 1994).

Our research suggests that asset specificity simultaneously generates two distinct incentives that create dependence by inducing the investing party to cooperate ex post: one *positive,* which promotes cooperation; the other *counter-negative*, which deters defection. The positive incentive exists because cooperation is a pre-requisite to reap the potential quasi-rent and retain the resources (Williamson, 1985; Parkhe, 1993; Anderson and Weitz, 1992). The counter-negative incentive exists because one would have to forego the quasi-rent and lose the committed resources when defecting. Thus, asset specificity has the effect of eschewing opportunism because opportunistic behavior risks the dissolution of a relationship, which runs counter to self-interest (Williamson, 1985; Anderson and Weitz, 1992; Morgan and Hunt, 1994).

Moreover, relationship-specific investments cannot be made in a vacuum but must necessarily be embedded in the context of a relationship that characterized *jointly* along the inter-personal and the inter-temporal dimension. The inter-personal dimension refers to the strength of social ties that generate trust while the inter-temporal dimension refers to the expected time horizon of future encounters (Granovetter, 1985; Uzzi, 1997; Sako and Helper, 1998; Heide and Miner, 1992; Axelrod, 1984; Artz and Brush, 2000). That greater trust and/or longer time horizon is more amenable to specific investments is intuitively appealing and supported by research (e.g., Uzzi, 1997; Morgan and Hunt, 1994; Chiles and McMakin, 1996; Nooteboom et al., 1997; Sako and Helper, 1998).

There is an extensive body of literature addressing the role of the relational context in encouraging specific investments across disciplines, including marketing, strategic