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Asset specificity's impact on outsourcing relationship performance: A disaggregated analysis by buyer–supplier asset specificity dimensions

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ABSTRACT

Using hierarchical regression analysis on a sample of UK service firms, this study tests the impact of asset specificity on outsourcing relationship performance within a disaggregated methodological framework that allows to discern the specific effects of various buyers and suppliers' individual dimensions of asset specific investments. The results indicate that the impact of asset specific investments on outsourcing relationship performance varies according to the particular specificity dimension examined. While all statistically significant dimensions of buyers' asset specificity have a negative impact on relationship satisfaction, suppliers' human and dedicated asset specific investments exert a positive and significant influence. The results also show that, in three interaction instances, reciprocal specific investments are positively associated with outsourcing relationship performance. These findings have profound theoretical and methodological implications.

1. Introduction

According to transaction cost theory (TCT), under buyer–supplier relationship conditions of asset specificity (i.e., relationships involving non re-deployable investments specifically dedicated to the relationship), having to incur transaction costs to safeguard against costly opportunism makes vertical integration, rather than outsourcing, the most efficient and, hence, preferable governance structure. The literature widely investigates the transaction cost explanation for companies' boundary choice versus market governance under asset specificity conditions, and provides this explanation with considerable empirical support (Anderson and Coughlan, 1987; Klein et al., 1990; Levy, 1985; Masten, 1984; Monteverde and Teece, 1982). However, the literature overlooks the TCT's implication for outsourcing relationship performance in the presence of asset specific investments. This gap is particularly striking when considering that although factors influencing the make-or-buy decision are of great significance, of no less importance and, possibly, of greater relevance is the question of what happens to those companies that do choose to outsource under asset specificity conditions. Given the considerable measurement and contracting costs to safeguard against the hazards of asset specificity, the reported difficulties in crafting complex contracts and the well-known problems of outsourcing relationships to realize expected benefits (PA Consulting Group, 1993, 1996), this line of inquiry is particularly timely.

The few studies that consider the question of the extent to which asset specific investments affect the performance of buyer–supplier relationships (Artz, 1999; Heide and Stump, 1995; Leiblein et al., 2002; Lui et al., 2009; Poppo and Zenger, 1998; Rodriguez and Padilla, 2005; Wang, 2002) produce mixed results from which discerning a conventional wisdom is difficult. These studies also bring to the fore a number of methodological and measurement issues. Aiming to address these issues, this study adds to this literature in a number of ways.

First, studies that test hypotheses from TCT often use a loose definition of the buyer–supplier transactional relationship, thus failing to distinguish between transactions that involve the mere procurement of raw materials and/or intermediary inputs, and those which actually entail the external relocation of previously vertically integrated functions (which is how this article defines the outsourcing transaction). This distinction is important in that although there is no reason to assume that previously integrated functions should operate differently from all other external activities, only the operationalization of the former can reveal the extent to which the buyer obtains benefits compared to in-house production, which is the conceptual premise for the scale development of outsourcing relationship performance in this study. The only studies that specifically investigate the effects of asset specificity on the performance of such a buyer–supplier relationship (Poppo and Zenger, 1998, 2002; Wang, 2002) do not differentiate between buyers and suppliers' investments nor do they disaggregate data according to asset specificity dimensions.

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Although both parties can undertake non re-deployable investments, with few notable exceptions (Artz, 1999; Buvik and Reve, 2001; Heide and John, 1990; Heide and Stump, 1995; Rokkan et al., 2003), previous empirical work only measures the asset specificity content of investments by one side of the buyer–supplier dyad. This study investigates the impact of asset specificity on outsourcing relationship performance while distinguishing between the effects pertaining to specific investments by both buyers and suppliers.

Prior work that tests the effect of asset specificity on any measure of performance also raises the critical issue of the actual operationalization of the asset specificity construct. Morill and Morill (2003) argue that such a construct is not directly observable, requiring the use of multiple indicators. In their systematic assessment of TCT-related literature, David and Han (2004, p.54) conclude that the term asset specificity means “many different things to different people”. Yet, as early as 1985, Anderson (1985) calls for a more consistent and comprehensive scale development in an effort to reach a better approximation of the construct's multi-dimensional nature. Though efforts to inform the asset specificity scale from items relating to more than a single dimension of specificity are not uncommon (Geyskens et al., 2006; Klein et al., 1990; Levy, 1985; Zaheer and Venkatraman, 1995), with the exception of Masten et al. (1989) and Maltz (1993) (who do not test effects on relationship performance), they all still end up with the estimation of a single, albeit composite, asset specificity coefficient. The present study goes a step further, by testing the impact of asset specificity on the basis of a wide menu of distinct dimensions of specific investments by both buyers and suppliers. The study also examines the effect of reciprocal specific investments (i.e. the interaction effects of buyers' and suppliers' asset specificity dimensions) while controlling for the role of firm size, length of the relationship, type of function being outsourced, and (service-sector) industry type.

To sum up, this is the first attempt that sets out to investigate empirically the direct impact of various dimensions of buyers and suppliers' asset specific investments on outsourcing relationship performance in relationships characterized by the externalization of previously integrated functions.

2. Theory and hypotheses

Williamson's (1971, 1975, 1985) TCT identifies particular transaction characteristics upon which the discriminating choice of governance (i.e., hierarchy, hybrid or market) can be optimized subject to rational, transaction-cost-minimizing constraints. The main tenets of TCT (from which the most popularly testable hypotheses derive) relate to the effect of governance choice on firm performance given the influence these transaction characteristics exert on the transaction-cost-minimizing tendency of the firm. These transaction characteristics are asset specificity (henceforth, AS), uncertainty, and frequency.

Williamson (1989, p.142) defines AS in terms of “the degree to which an asset can be redeployed to alternative uses by alternative users without sacrifice of productive value”. The presence of asset specific investments gives rise to a safeguarding problem against opportunistic behavior. TCT, therefore, predicts that transactions characterized by high AS will be performed under a hierarchy, given the firm's ability to economize on contractual and monitoring costs through its more efficient internal control and conflict resolution mechanisms (Williamson, 1971, 1999). Uncertainty captures the degree to which *ex-ante* contractual costs and *ex-post* monitoring and enforcing costs are augmented by environmental and behavioral unpredictability, respectively. Conditional upon the presence of AS, the effect of uncertainty is to push transactions away from the market and towards a hierarchy since uncertainty incentivizes expropriation when a party's specific investment is exposed. Finally, the greater the frequency of transactions, the greater the monitoring costs. Transaction-cost-minimization, therefore, makes governance through firm organization the preferable structure. Between the two extremes, market and hierarchy, lie hybrid relational structures which firms should favor in the absence of uncertainty and when frequent transactions occur at the intermediate range of AS (Williamson, 1985, 1991; Powell, 1990). Hybrid structures should allow firms to reap some of the benefits of vertical integration (lower transaction costs) alongside the economic gains that accrue from market transactions (in the case of outsourcing, cost savings and value adding).

For a comprehensive assessment of the typical hypotheses developed from TCT's core propositions, this article refers the reader to the important reviews by Leiblein (2003), David and Han (2004) and Geyskens et al. (2006). On the other hand, the present study's interest centers on interrogating TCT on a different (though not unrelated) and still under-researched question. Specifically, this study asks whether TCT has anything to say on what happens to relational performance in the presence of deviations from the optimal form of governance predicted by the theory's core tenets, that is, what happens to relational performance in outsourcing relationships characterized by asset specific investments. TCT postulates that the hostage of asset specific investments increases the risk of opportunistic expropriation that stems from newly acquired (post-contracting) bargaining power and the threat of contract termination (Klein et al., 1978). This hazard creates what Williamson (1985) describes as a monopoly relationship whereby the disadvantaged party faces the unpleasant choice of continuing to work with its opportunistic partner or forgo the expected value of its specific investment (Anderson and Coughlan, 1987). Failure to safeguard against costly opportunism through adequate contracts essentially means that the party undertaking specific investments will be locked into the transaction, and will be vulnerable to opportunistic expropriation in the form of lower quality of the product/service and/or price/cost losses to the detriment of outsourcing performance (Klein et al., 1978). Against this backdrop, the answer of TCT to the research question that this study poses appears unambiguous. Under the hazards of AS, a high degree of uncertainty makes market governance “subject to costly haggling and maladaptiveness” (Williamson, 1985, p.89). Hence, TCT not only predicts that a hierarchy is the most effective governance mode because it reduces the costs of drafting and negotiating contracts necessary to safeguard the productive value of exposed assets. TCT also implies that should this transaction be performed through the market, unilateral specific investments will have negative economic and qualitative consequences on the performance of the outsourcing relationship.

Exposure to opportunism is evidently more pronounced under conditions where the supplier unilaterally employs specific assets (Buvik and Reve, 2001). Faced with the buyer's opportunism while being locked into the relationship, the supplier's only option to save on the costs of the relationship is to cut back on the operational resources devoted to the focal product or service with a consequent negative impact on delivery performance as well as buyer's satisfaction. Under conditions where the buyer unilaterally employs specific investments, as eloquently put by Artz (1999, p.117):

> “TCE arguments predict that these assets can also have a negative effect on the OEM [Original Equipment Manufacturer]. Since specialized assets are worth little outside the present relationship, the OEM is dependent on the good-faith behaviour of the supplier to realize the value of its investment. Consequently, OEM control over that supplier is reduced (Heide and John, 1992). As control declines, the OEM is forced to expend more time and effort negotiating and monitoring contracts to safeguard its investment.. […]..Furthermore, since the supplier knows the OEM is at least somewhat ‘locked in’ to the relationship, its incentive to provide superior delivery performance is reduced. The increased transac-