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SIGNIFICANCE OF REPUTATION THROUGH THE PERSPECTIVE OF ASSET SPECIFICITY TRANSACTION COST THEORY

VAŽNOST UGLEDA KAO SPECIFIČNE VRIJEDNOSTI U TEORIJI TROŠKOVA TRANSAKCIJE

ABSTRACT

The purpose of this paper is to examine the influence of reputation and Oliver Williamson's conception of asset specificity as drivers for competitiveness. More specifically, this paper develops the idea of reputation as it relates to buyer/supplier relationships. A consideration of the costs associated with economic exchange can yield insights and help guide corporate strategy as to whether to acquire an asset, what to outsource or vertically integrate, where to situate a business, or whether to invest in a dedicated supplier. Reputation can affect business outcomes through the channel of asset specificity and can be analyzed through the lens of transaction costs.

Key words: *Reputation, asset specificity, transaction costs, competitive advantage, supplier relationships, business networks*

SAŽETAK

Svrha ovog rada je preispitati utjecaj ugleda u Transakciji Pregovaranja Olivera Williamsona i koncepcije specifične vrijednosti (asset) kao inicijatora konkurentnosti. Točnije, ovaj rad razmatra ideju važnosti ugleda u uzajmnom odnosu kupca/dobavljača. Razmatranje troškova povezanih sa ekonomskim razmjenama može pridonijeti točnijem uvidu i pomoći razvoju korporacijske strategije u odlučivanju specifične vrijednosti (asset); da li outsource ili se okomito integrirati, u odabranju lokacije ili ulaganja u odredenog dobavljača. Ugled može utjecati na poslovne rezultate kroz specifične vrijednosti (asset) i mogu se analizirati kroz prizmu troškova transakcije.

Ključne riječi: *Ugled, specifične vrijednosti (asset), transakcijski troškovi, konkurentska prednost, odnos s dobavljačima, poslovnim mrežama*

1. Introduction

Transaction cost economics (TCE) is a framework that can be used to make complex strategic decisions that impact the performance of a firm. In many ways, TCE provides an answer to some of the shortcomings in standard neoclassical theory. As explained by Robert Salomon "transaction cost economics is a central theory in the field of strategy. It addresses questions about why firms exist (i.e., to minimize transaction costs), how firms define their boundaries, and how they ought to govern operations." (Salomon, 2015). Since business transactions are a key part of operations, an understanding of where and how transaction costs occur can yield insight into why total costs can be different between firms. It is not just direct costs that are of concern but also indirect costs that affect and are affected by differences in quality and delivery. While this approach may provide an understanding of current positioning in its marketplace, continuous evaluation of where to invest capital, and whether to focus on outsourcing or vertical integration are important considerations for minimizing transaction costs and sustaining competitive advantage.

According to Oliver Williamson, the determinants of transaction costs are frequency, specificity, uncertainty, limited rationality and opportunistic behavior (Williamson, 1981). These classifications are broad and their meanings are interpreted in many ways.
The importance of TCE to business is found through the process of evaluating transaction costs, which can be undertaken at the level of individual transactions as well as on a macro strategic level. Since costs are an unavoidable aspect of running a firm and are inherent in the business process, consideration and potential quantification of transaction costs can lead to more insightful decision-making. For example, in the absence of private investors, firms can request loans from a bank in order to expand their operations. These bank loans can have covenants in which a firm is compelled to follow the stipulations of the bank which may be overly restrictive and result in excessive transaction costs through such things as reporting on key metrics and focusing on creditor needs instead of customer needs. As described by Apitado and Millington (1992), a bank's competitive position may be improved through careful matching of risk, loan covenants and interest rates for small business lending. The authors also suggest that small companies might be more selective in the types of covenant and loan agreements and banks they sign with (Apitado and Millington, 1992). These restrictions add to a firm's transaction costs as they take away from customer-focused value-added functions. In a competitive market, a rival firm can displace a firm that is less customer-focused due to the emphasis to meet bank agreements.

Previous authors have treated the internal workings of a company as a 'black-box' with the justification that it was sufficient to know that it operated to maximize profits. (Slitter and Spencer, 2000). This perspective however rendered the firm and the entrepreneur as passive entities. More recently, firms have been recognized to be much more multi-dimensional. To illustrate, in the aftermath of high-profile corporate scandals such as those involving Tyco (Mykhailenko, 2015), Enron (Ailon, 2015) and Bernard L. Madoff Investment Securities (Abramovich, 2009), corporate reputation and trust have become important strategic elements and economic drivers in addition to profit maximization. Equally importantly, Oliver Williamson's theory of transaction cost economics identified and helped popularize the importance of asset specificity, frequency, uncertainty, limited rationality and opportunistic behaviour in the economic governance of business enterprise (Williamson, 1983). This paper examines the relationship between corporate reputation and asset specificity as it applies to supplier relationships and business networks more generally.

2. Reputation

There are many competing definitions of reputation as it applies to business entities. To narrow down the multitude of suggestions for defining corporate reputation, this paper focuses on Fombrun and Shanley (1990) which defines reputation as "a perceptual representation of a company's past actions and future prospects that describe the firm's overall appeal to all its key constituents when compared to other leading rivals" (Fombrun and Shanley 1990). Reputation is one way a firm can differentiate itself from competitors.

In today's technological world, reputation is ubiquitous as consumers can access online reviews on many products. A lost customer can affect future sales due to harsh online posts (regardless if they are unfounded). These feedback mechanisms (i.e. online and text-comment reviews) have been shown to partly influence a seller's credibility (Ba and Pavlou, 2002; Pavlou and Dimoka, 2006). Therefore, customer satisfaction is also about new customer revenue especially in today's connected society. As described in Connellan and Zemkeis' (1993) "customer retention is simply a matter of defining and measuring proper variables" (Connellan and Zemkeis, 1993). Reputation may be one of these variables.

Fombrun and Shanley (1990) further describes the importance of reputation: "a good reputation permits a company to command premium prices for its products, pay lower prices for purchases through its ability to leverage in negotiations, recruit the top candidates to its company, enhance employee morale and loyalty" (Kowalczyk, 2002). Specific skills, when executed proficiently, can raise a firm's reputation and help lower transaction costs. In short, reputation is good for business. How reputation can affect a firm's bottom line is the topic of the following sections.

3. Theory: Asset Specificity

Of the five components of TCE outlined in Williamson (1983), this paper focuses on asset specificity. Williamson classified asset specificity into the following four categories: physical, site, human and dedicated (Williamson 1983). The first, physical, refers to fixed assets used in production. A company where a specific physical asset exists to produce a specific product, for example, can increase reputation due to being able to produce something where a rival firm could not compete. This reputation can translate into a heightened competitive advantage. The second, site, refers to the geographic location of a particular asset where relocation would incur significant costs. By virtue of proximity to either a customer or supplier, site specificity can have positive impacts as the immediacy to meeting an urgent request can be fulfilled and as a result increase the reputation inherent in a supplier/buyer relationship. The third aspect of asset specificity, human, refers to the acquired skills and knowledge of employees specific to a process or operation. A firm that rewards its employees through training, mentoring and incentives can result in lowered rates of employee attrition, heightened ability to attract high quality employees and increased productivity. The fourth, dedicated asset specificity, refers to the investments made on fixed assets that are required to conduct business with a specific trade partner. Suppliers that consider a customer to be reputable will more likely invest in a specific fixed asset for that particular customer, and *vice versa*. In other words, if "firms are able to induce suppliers/customers to undertake more relationship-specific investments, then this may result in longer relationship duration since such investments are less valuable outside the relationship" (Raman and Shahrur, 2008). Each of these four components of asset specificity will further be examined in relation to reputation, using hypothetical examples of supplier relationships.

3.1. Physical Asset Specificity

Highly specific or specialized physical assets can be used to differentiate a company from its rivals through improvements in efficiency, quality and/or productivity, and these improvements can result in a heightened competitive advantage. This has a 'spill-over' effect where reputation can be gained and this too can positively affect a buyer's competitive advantage in its marketplace. For example, a specific machine which produces a superior product for a customer has dual benefits. First, the supplier who owns the specific machine may have a competitive advantage over rival firms. Second, customers may benefit due to receiving a better product, with the assumption that the supplier only sells this product to a specific customer. As result of an improved buyer supplier relationship both companies stand to benefit from lowered transaction costs. For example, Ford assembles cars from manufacturer components, some of which are outsourced. Some components are complex and require specialized machines to manufacture. As described by Vandergrift (1998) a strategic decision is whether to outsource a complex part such an air-conditioner assembly. Without the proper investment in a specific machine it would not be possible to manufacture the air-conditioner assembly in-house competitively. However, controlling quality and intellectual property is best done if the assembly is manufactured in-house. Ford might ask the question whether air-conditioners are a key differentiating factor as to why customers purchase their vehicles. What is the opportunity cost to invest alternatively in another specific asset? Can air-conditioner manufacturers also sell to other car original equipment manufacturers (OEMs) thereby lower costs through economies of scale? What does Ford want to be known for? Specializing in assets that have a high value-add is a good strategic initiative.

3.2. Site Asset Specificity

The business benefit of geographic location can be due to being close to customers or suppliers or to a shipping corridor such as rail, waterway or highway. These are all factors where transaction costs vary based on geographic location. Costs are identifiable when close proximity results in reductions in inventory and other related processing costs (De Vita, 2011). Moreover, the costs to relocate certain assets (once in place) can be very high and are thus associated with a high degree of immobility (Williamson 1983). Site asset specificity can result in competitive advantage when rival firms cannot easily transfer their operations to other more advantageous locations. Site specificity can also provide competitive advantage through increased ability to develop business relationships due to proximity to customers and suppliers. A firm located near a port, highway and other major arteries of transportation, for example, can be advantageous (especially if customer is not within close proximity) to lower transaction costs associated with logistics. Also, a particular advantageous location where there is a large pool of local skilled labour can help with attracting top talent.

3.3. Human Asset Specificity

Transaction costs of human capital relate to the managing and training of a firm's employees. When a firm's asset is specific, it has an inherent value to a particular buyer. The specificity of skills can be measured in terms of how transferable it is in the marketplace – the more specific the less transferable or portable (Iversen and Soskice 2001). Investing in human capital, such as training on a highly specialized machine, software, or management program can increase the specificity of human capital. "Completely general training increases the marginal productivity of trainees by exactly the same amount in the firms providing the training as in other firms. [...] Completely specific training can be defined as training that has no effect on the productivity of trainees that would be useful in other firms" (Becker, 1993). In general, "if you give your employees the chance to learn and grow, they'll thrive—and so will your organization" (Spreitzer and Porath, 2012). The positive outcome of skills training is that it increases performance (Teodora et al, 2013) and improves company reputation (Suttapong et al, 2014). A good reputation also positively affects relations with customers and may also attract well-educated employees, which can result in higher productivity (Rose and Steen, 2004). Higher productivity is a function of training and hiring skilled employees and similarly, a reputable firm will be able to attract and retain top talent.

3.4. Dedicated Asset Specificity

An example of dedicated asset specificity can be found in supplier contract negotiations. In contract negotiation, the associated cost to cover all aspects with respect to roles and responsibilities of each party needs to be reflected in the contract. A firm benefits in lowering transactions costs as the organizational culture and reputation increase the level of mutual trust (Obloj and Obloj, 2006). When trust is high and reputation is positive there is less emphasis on the contract as being the sole decision to proceed. There may be less re-negotiating and emphasis on the legal framework due to the existing business network. Reputation is evident in many cultures when conducting business and can be found in *blat* in Russian (Ledeneva, 2009), *wasta* in Middle Eastern culture (Meed, 2006), *sociolismo* via 'market socialism' in Cuba (Ritter, 2014), the "old boys' club" in Anglo-Saxon culture (Inci and Parker, 2013), and *dignitas* in Roman culture (Elwitt, 1977).

An extreme example of dedicated asset specificity can be found in the *keiretsu* business networks that formed in Japanese business culture. These networks have such strong dedicated asset specificity that U.S. antitrust regulators have criticized them as business 'cartels' (Davidow, 1993). Within these closed networks the "supplier relationships in Japan are efficient due to more effective coordination and more complete information sharing" (Dyer, 1996). Transaction costs are significantly lowered through "the ability of the Japanese value chain to 'learn' and quickly develop high quality, complex products" (Dyer, 1996). When select suppliers are part of the *keiretsu*, each respective supplier can develop their asset specific focus and maintain their competitiveness in the global marketplace. In the U.S., firms are more vertically integrated than in Japan. As a result it is harder for firms to maintain asset specificity advantage in the absence of a strong supplier relationship (Dyer, 1996). As the common business saying goes ‘do what you do best and outsource the rest’ is best implemented if a reputation and strong supplier relationships exist.

4. Reputation as an asset

Assets are used to facilitate operations in a business and can be used to acquire new business. Reputation is not a purchasable item and therefore is difficult to quantify; however, reputation has the ability to lower transaction costs (Dyer and Chu, 2003). In an attempt to find out the components of corporate reputation a survey of 650 CEOs almost three-quarters listed ‘trustworthiness’ and ‘high-quality products and services’ as the most important followed by ‘high-caliber management team’, (43 percent); ‘the sense the company adds value to all customer transactions’, (39 percent); ‘the impression that the company conducts business in a caring way’, (28 percent); and ‘an established reputation for innovation’, (23 percent) (Winkleman, 1999). The stated components are key differentiators that CEOs monitor and invest in that are part of a firm’s value-added practices.

To measure reputation as an asset, research by Cravens et al. (2003) suggests a reputation index be weighed on the following “specific measures relating to: products, employees, external relationships, innovation and value creation, financial strength and viability, strategy, culture, and intangible liabilities” (Cravens et al., 2003). As described, reputation is a multifactorial entity and these factors are weighted differently for each firm. For instance, a firm that relies heavily on outsourcing has to be cognizant of, and monitor, its external relationships as a key component to its reputation and business. Moreover, *ceteris paribus* a technological firm will vie for skilled human capital more successfully if it is perceived in a reputable and positive light with respect to its workforce. Depending on the operations of the firm key reputation drivers vary.

Since reputable companies are better able to secure more business, this trait should be considered an asset. “In time, favourable perceptions crystallise into the intangible asset of a corporate reputation. These reputations have economic value because they affect a company's bottom line” (Fombrun, 2000). To evaluate the true value of reputation is inherently difficult and is sometimes seen as goodwill on a financial statement. The justification to spend funds on reputation often has to be made by appealing to public relations and marketing departments but should to be done through return on investment reasoning.

“Reputations are not built quickly, nor can they be bought and sold. A firm with a positive reputation can enjoy a significant competitive advantage, whereas a firm with a negative reputation, or no reputation, may have to invest significant amounts over long periods of time to match the differentiated firm” (Kowalczyk, 2002). Long-term relationships are an outcome of trust between the buyer-seller over a period of time. This social connection where both trading partners are benefiting from the outcome of their transactions “has been suggested that the study of business relationships must take into account not only the characteristics of the transaction in question, but also the characteristics of the relationship itself” (De Vita, 2011). The dedication to reputation needs to consider the individual transaction as well as the relationship as a whole, in order for the company to benefit over the long-term. Assets add value to a company’s business. The dedication to reputation is one value-added initiative that CEOs consider to be good for business.

5. Conclusion

The explorations in this paper suggest reputation may be of key importance to customers and suppliers. The adherence to developing reputation with respect to asset specificity and *vice versa* creates a positive spillover where both influence each other in positive ways. Firms with strongly positive reputations are able to achieve competitive advantage over their rivals through lowering their transaction costs. This advantage may take a number of forms, and can be realized through the four channels of asset specificity described in this paper. Reputation can be a powerful force for improving a company's bottom line.

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