2. transaction cost theory

The transaction cost approach to the study of economic organization regards the transaction as the basic unit of analysis and holds that an understanding of transaction cost economizing is central to the study of organizations. Applications of this approach require that transactions be dimensionalized and that alternative governance structures be described. Economizing is accomplished by assigning transactions to governance structures in a discriminating way. The approach applies both to the determination of efficient boundaries, as between firms and markets, and to the organization of internal transactions, including the design of employment relations. The approach is compared and contrasted with selected parts of the organization theory literature.

2.1. Transaction Cost Definition:

Transaction cost is the expense one incurs by engaging in economic exchange of any kind. Any activities associated with a market generate transactional costs. They represent the trade expenses that one needs to cover for aiding the exchange of goods and services in a market.

Examples of common transaction costs are labor, transportation, broker fees, bank charges, commissions, etc. The nature and magnitude of transaction costs vary in different business scenarios. Nevertheless, these costs play a huge role in business management and economic growth.

There are three main **types of transaction costs**. Let us explore each with the help of an example. Suppose a person is trying to buy a house. Here the **transaction costs include**:

- **Search Costs:** These are the costs of searching for information on sellers or availing services that can help a person find the best commodity. Some examples are communication and consulting fees, advertising expenses, travel expenses, etc. The individual trying to buy the house pays a real estate agent to help them find the perfect property. Here, they incur search costs to find the right commodity (a house).
- **Bargaining costs:** These are the costs related to negotiation and conflicting interests regarding trading until the transacting parties agree. An individual has to spend time and labor looking at different houses and negotiating the price with the owners. Here they are incurring bargaining costs.
- **Enforcement costs:** These are the expenses one incurs to verify and ensure that the parties involved in a contract comply with its terms. It relates to the time, money, and effort taken by a person to ensure that everyone meets the terms of the agreement. The person who is finally planning to purchase hires a lawyer has to draw up the paperwork for sale. In this case, they are paying for the enforcement costs**.**

2.2. Transaction Cost Theory in Economics

One of the prevailing economic-based theories of organizational corporate governance is the transaction cost theory. According to Coase, its origin can be

traced back to the 1930s. However, the idea of transaction costs is recognized as a useful analytical tool in the 1970s through works of several authors, for instance, Oliver Williamson. The transaction cost theory states that a firm as a sum of contracts put in practice in order to organize and regulate transactions serves for accomplishing contractual relations. Its main concern is in carrying out economic transactions based on the most efficient governance structure. Transaction costs refer to explicit fees associated with a transaction as well as implicit fees of monitoring and controlling a transaction. Transaction cost includes the costs of information, search, negotiation in addition to contracting and enforcement. The economic implication is decision-makers have to weigh costs associated with performing an activity in-house against that of outsourcing it to the market. Thus, if the transaction cost of using the market is higher, the transaction should be executed by the firm (in-sourcing). In addition, if they choose to execute a transaction through the market, they have to determine the most appropriate contract to use.

With regard to the choice of governance structure by decision-makers, human and environmental factors influences the decision makers attributed.

2.3. Assumptions of transaction cost theory

transaction cost theory rests upon several key assumptions about human behavior and environmental characteristics. These assumptions elucidate why firms may face superior costs for market-based transactions and why firms may be relatively more efficient than markets at organizing transactions. The firm will select the governance form, from the various alternatives amongst the organizational menu, that minimizes transaction and production costs.

2.3.1. Assumptions about human and human behavior

- **Opportunism with guile**: In neoclassical economics, humans are viewed as self-interested; individuals pursue their own self-interest in their own activities. Opportunism with guile takes this assumption a step further to assume that individuals may engage in behavior that is both subtly and overtly deceitful ex ante and ex post to agreeing on contracts. As Williamson puts it "Plainly, were it not for opportunism, all behavior could be rule governed". In fact, it is precisely because sometimes some individuals behave opportunistically that there are costs to exchange. The opportunism assumption is about the motivations of human behavior. This assumption is central to TCT because, in the absence of potentially opportunistic behaviors, contracts would be costlessly enforced and there would be no reason for other forms of economic organization besides the market.
- **Bounded rationality**: The neoclassical theory assumes that individuals have perfect information and act as utility maximizers with calculative rationality. In sharp contrast, the TCT views human as boundedly rational - individuals are "intendedlly rational, but only limitedly so". Bounded rationality reflects individuals' inability to process large degrees of information and their difficulty in assigning probability values to the occurrence of future events. It is worth noting that bounded rationality does not imply that individuals seek to be

irrational. In fact, they seek to make rational decisions but within the limits of their imperfect cognitive abilities and in conditions of imperfect information.

2.3.2. Assumptions about environmental characteristics

- **Asset specificity**: Williamson defined asset specificity as “durable investments that are undertaken in support of particular transactions, the opportunity cost of which investment is much lower in best alternative uses or by alternative users should be original transaction be prematurely terminated.
- **Uncertainty**: Uncertainty is a straightforward assumption and it contrasts with the perfect-information assumption of the neoclassical view. Information about past, current and future states is not perfectly known, for various reasons. Without the existence of bounded rationality and opportunism, uncertainty would be much less of a problem because general rules would generally prevail.
- **Frequency of the transactions**: If transactions are infrequent then the costs of alternative governance structures may not be justified. A larger frequency or larger volumes of transactions, however, gives rise to justification for alternative governance structures such as the firm. Therefore, the volume, number, and/or temporal spread of transactions are important to be considered because even given the previous assumptions if they are infrequent alternative governance structures may not be necessary or feasible. The degree of frequency ranges from occasional to recurrent.