Theory of Transaction Costs

Лекция по дисциплине «Институциональная экономика»

The purpose of the lecture: to use instruments of new institutional economics to analyse transaction costs

The founding father of Transaction Costs theory is **Ronald Coase,** who, in 1937, wrote an article entitled “**The nature of the Firm”**.

Transaction costs have become a very significant category in Coasean economics.
“Without them, many aspects of the functioning of the economic system remain unexplained, including the emergence of the firm itself”

Transaction Costs: Definitions

- Transaction costs are "the costs of using the price mechanism" *(R. Coase, 1937)*

- Transaction costs are the costs stemming from applying the price mechanism. In other words, these are the costs of negotiating contracts, monitoring performance and getting to know trading partners *(Parada, 2002).*

- "Transaction costs are the costs of running the economic system" *(Kenneth Arrow, 1969).*

- Transaction costs are the costs of "discovering market prices and the costs of drawing up and enforcing contracts" *(Organisation for Economic Co-operation and Development [OECD], 1993).*

Transaction Costs: Definitions

- Transaction Costs are the costs establishing and maintaining property rights *(Allen, 1991).*

- "Transaction cost may be defined as the cost of exchanging ownership titles" *(Demsetz,1964).*

- Transaction costs appear when a service or goods are transferred through a technologically separate interface *(O. Williamson).* That definition shows that the transaction is not only a market exchange, but it covers all the exchange procedures within the organization

Transaction Costs: meaning

The economic counterpart of friction is transaction cost

Oliver Williamson

“Without taking into account transaction costs it is impossible to understand properly the working of the economic system and have a sound basis for establishing economic policy”

R. Coase

Transaction costs – any costs that are not conceivable in a "Robinson Crusoe economy”

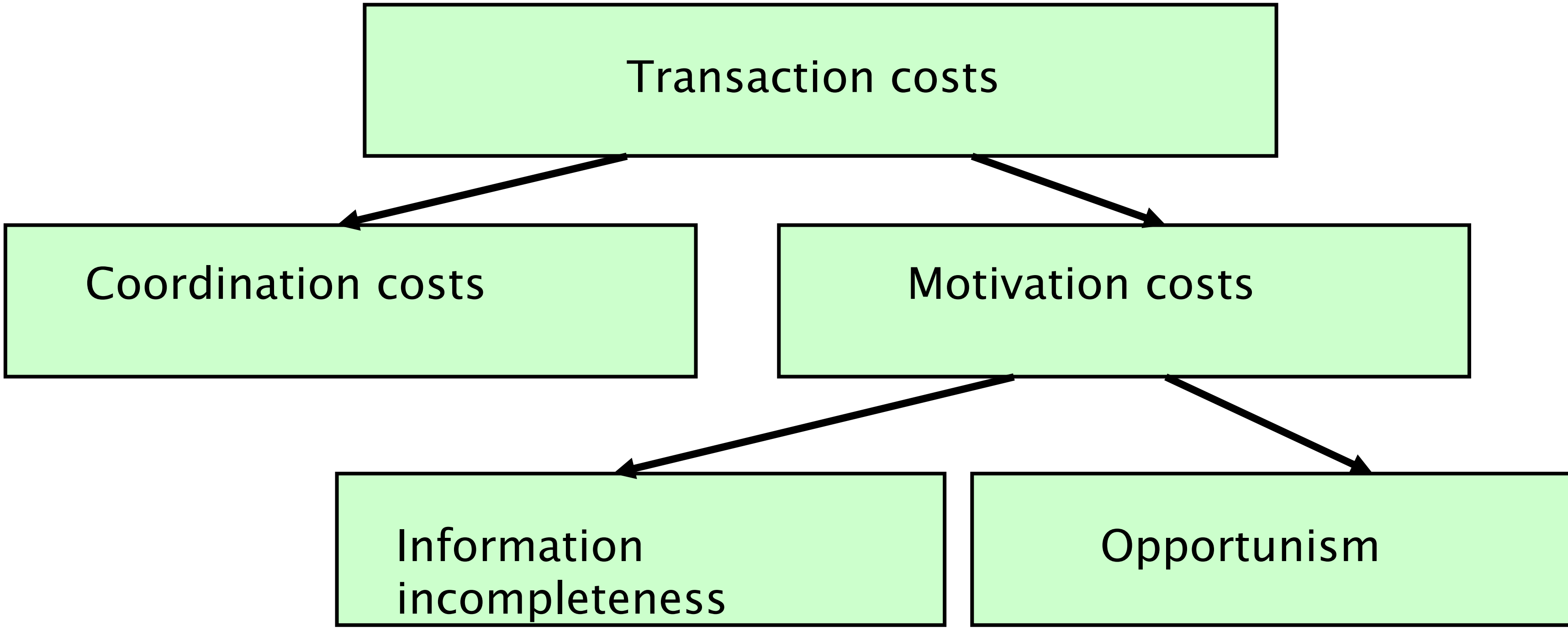
S. Cheung

Under what assumptions transaction costs arise?

- Incomplete and imperfect information
- Imperfect specification of property rights
- Opportunism

Opportunism is a self-interest seeking with guile (Oliver Williamson)

The classification of transaction costs (Milgrom and Roberts)



Coordination costs

- Coordination costs are “related to the need to determine prices and other details of the transaction, to make the existence and location of potential buyers and sellers known to one another, and to bring the buyers and sellers together to transact.”

  Milgrom and Roberts

Motivation costs

- Two types of motivation costs: those associated with informational incompleteness and asymmetries, and those associated with opportunism

- *Informational incompleteness and asymmetries*

These type of transaction costs are present “when the parties to the transaction do not have all the relevant information needed to determine whether the terms of an agreement are acceptable and whether they are actually being met.”

Milgrom and Roberts

Motivation costs

Opportunism

These costs deriving from "the inability of parties to bind themselves to follow through on threats and promises that they would like to make but which, having made, they would like to renounce."

Milgrom and Roberts

Transaction cost classification: (North – Eggertsson)

ex ante

- Search cost
- Bargaining cost
- Contract-making cost

ex post

- Monitoring cost
- Enforcement cost
- Protection from 3rd party

Transaction cost classification: (North – Eggertsson) [Ex ante]

Search strategies (how search is organized)

- Anonymous market
- Specialized agents
- Social networks

What agents search for?

- Prices
- Quality
- Information about potential partners

Transaction cost classification: (North – Eggertsson) [Ex ante]

Bargaining costs, including

- Communication cost – Direct bargaining costs (due to language and cultural differences)
- Strategic cost – Signals to potential partners
- Cost of delayed agreement – Alternative costs

Contract-making cost

- Lawyer costs
- Taxes as transaction goods

Transaction cost classification: (North – Eggertsson) [Ex post]

Monitoring

- Direct and indirect cost of monitoring

Enforcement cost

- Incentive
- Taxes as transaction goods (we pay to get access to enforcement system)

Protection from 3rd parties

- State
- Competitors
- Organized crime etc

Transaction goods

– institutions and technologies that individuals can get access to (on free or paid basis) with the aim to decrease individual costs of transacting (transaction cost)

Transaction goods

Fields	Transaction goods
Contracts	Standard forms of contracts; Enforcement system
Measurement	Money; metrology; quality standards
Property rights protection	Titles of ownership; Court and penitentiary systems
Informational infrastructure	Legal and statistical information

Transaction cost and opportunism

If you seek to minimize ex ante transaction cost, it may lead to high ex post transaction cost

Ex ante opportunism – adverse selection

Ex post opportunism – moral hazard and hold-up

Classification of goods based on measurement cost

Inspection (search) goods

Experimental goods

Credence goods

Inspection (search) goods: those with attributes that can be evaluated prior to purchase or consumption. Consumers rely on prior experience, direct product inspection and other information search activities to locate information that assists in the evaluation process. Most products fall into the search goods category (e.g. clothing, office stationery, home furnishings).

Experience goods: those that can be accurately evaluated only after the product has been purchased and experienced. Many personal services fall into this category (e.g. restaurant, hairdresser, beauty salon, theme park, travel, holiday).

Credence claims: those that are difficult or impossible to evaluate even after consumption has occurred. Evaluation difficulties may arise because the consumer lacks the knowledge or technical expertise to make a realistic evaluation or, alternatively because the cost of information-acquisition may outweigh the value of the information available. Many professional services fall into this category (e.g. accountant, legal services, repair services, medical treatments or a taxi ride in an unknown city)

Institutions and mechanisms that help to decrease transaction costs :

- ✓ Warranties
- ✓ Standards
- ✓ Licenses
- ✓ Trademarks
- ✓ Reputation
- ✓ Metrology

The market mechanism can itself generate new products or services targeted at reducing transaction costs.

- Market Research services are the most obvious example, in which information on the qualities and prices of different goods is compiled by an agent who is seen to be objective and then sold as a product in itself in order to reduce "search costs".
- The role of "middlemen" or brokers of different kinds is also created by the recognition of the value of having specialised knowledge both of the prospective buyers and the prospective sellers of specific goods or services. Such services should serve to reduce both search costs and bargaining costs.
- Similarly, new types of services may come onto the market-place to reduce the costs of contract enforcement, such as debt collection services and specific types of insurance.

The institutions and rules which govern how markets work may also be adapted and refined so as to reduce transaction costs.

- The most obvious example of this is the introduction of standard weights and measures and quality standards which make it easier for products to be directly compared.
- The creation of “market-places” in which buyers and sellers of specific products assemble at known times and places is another obvious institutional mechanism for reducing search costs.
- There are also more complex informal rules and codes of conduct which govern how negotiations may be closed and contracts enforced within particular types of markets or amongst specific societies or groups of people.
- Specifically, where established codes of conduct serve to create increased trust, transaction costs are seen to fall considerably and this may be a key explanatory factor for why markets grow faster within certain societies and locations .

Measuring the level of transaction costs

Difficulty of empirical measures of transaction costs

- Lack of consensus over what the most important elements of transaction costs are
- A close functional relationship between transaction and transformation costs
- High cost of direct measurements
- Difficulty in choosing indicators

Measuring the Transaction Sector in the American Economy, 1870-1970
John Joseph Wallis and Douglass C. North

- The first study that have attempted to measure the level of transaction costs is Wallis and North (1986)
- They attempt to measure the entire transaction sector of the economy over 100 years.

Wallis and North

- Every economic activity involves elements of transaction and other costs. Ideally our measure of transaction costs would delve into each exchange and separate these costs. Unfortunately, data are not available for such a measure.
- Transaction costs are the costs associated with making exchanges, the costs of performing the transaction function.
- Transformation costs are the costs associated with transforming inputs into outputs, the costs of performing the transformation function.
- Transaction costs include the value of the labor, land, capital, and entrepreneurial skill used in making- exchanges.

Wallis and North

An analysis of four types of relationships and corresponding activities:

- the simple relationship between a buyer and a seller
- the transaction costs that occur within firms
- the transaction costs that occur through intermediaries of various types
- problem of protecting property rights.

Wallis and North

Selling and buying a house

- The buyer's transaction costs include the time spent looking at houses, obtaining information on prices and alternative housing, legal fees, the costs of establishing credibility as a buyer, and so on.

- The seller's transaction costs include the realtor, advertising, time spent waiting while people tramp through the house, title insurance, the cost of establishing credibility as a seller, and so on.

Wallis and North

- We can observe and measure the transaction costs embodied in the marketed services of the lawyers and realtors; we cannot observe the transaction costs of searching for houses or waiting for buyers.
- Transaction services are the observable element of transaction costs. In the example of the house, lawyers and realtors provide transaction services.
- We attempt to measure the level of transaction services provided in the economy, not the level of total transaction costs.

Wallis and North

Estimating the transaction sector within firms.

- First, we identify occupations that are primarily concerned with transaction functions. These include occupations concerned with the purchase of inputs, the distribution of outputs, and the coordination and monitoring of the transformation function within the firm.
- Second, we estimate the wage payments going to employees in transaction occupations. Those wage payments constitute our measure of the size of the transaction sector within firms.

Wallis and North

"Transaction industries" (Intermediaries):

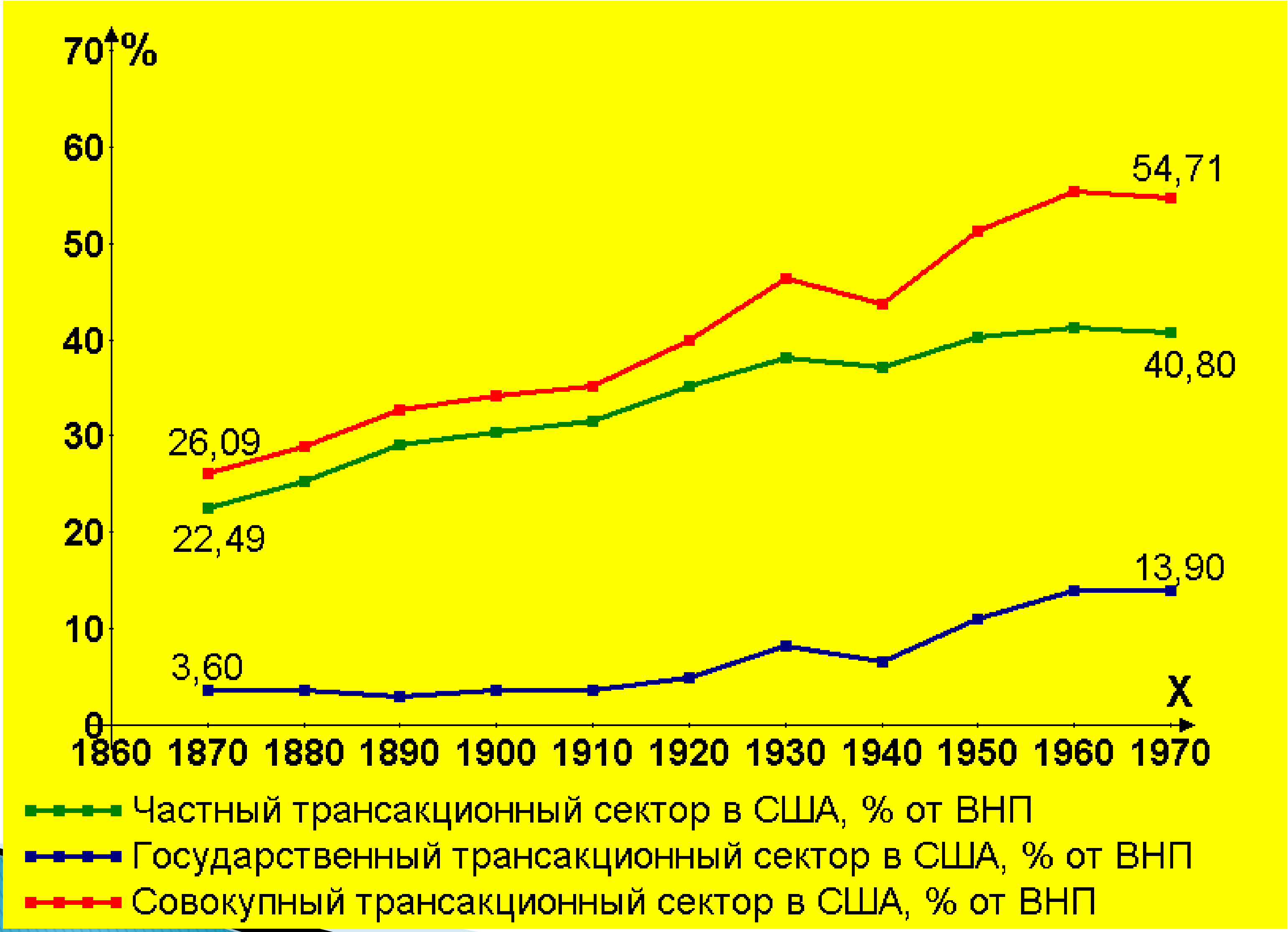
- real estate and finance, whose role is primarily to facilitate the transfer of ownership;
- banking and insurance, whose role is to intermediate in the exchange of contingent claims;
- the legal profession, whose primary role is to facilitate the coordination, enactment, and monitoring of contracts;
- Wholesale Trade, and Retail Trade.

Wallis and North

The protection of property rights:

- police
- guards
- Sheriffs
- courts

Measuring the Transaction Sector in the American Economy, 1870–1970 (Wallis and North)



Wallis and North

Major reasons why transaction costs have risen

- First, the costs of specifying and enforcing contracts became more important with the expansion of the market and growing urbanization.

As the economy becomes more specialized and urbanized, more and more exchanges are carried out between individuals who have no long-standing relations, that is, impersonal exchange. In contrast to personal exchange, where repeated dealing and intimate knowledge of the other party reduced the cost of contracting, impersonal exchange required detailed specification of the attributes of what was being exchanged or of the performance of agents, as well as elaborate enforcement mechanisms.

Wallis and North

- Second, the effect of technological change

The new capital intensive production techniques were often more profitable to operate (i.e., lower costs) at high output levels.

The high output levels increase costs on the coordination of inputs and outputs and monitoring the numerous contracts involved in production and distribution.

- Third, the declining costs of using the political system to restructure property rights.

Additional Reading:

J. Wallis and D. North Measuring the Transaction Sector in the American Economy, 1870-1970