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# Transaction Cost Economics: The Natural Progression☆

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**Abstract**

This manuscript provides the Nobel laureate's reflections on transaction cost economics. The overview section frames governance as the overarching concept and transaction cost economics as the means by which to breathe operational content into governance and organization. The vertical integration section identifies efficiency factors associated with determining when a firm produces a good or service to its own needs rather than outsource. A discussion of the rudiments of transaction cost analysis is subsequently provided. Puzzles and challenges that require pushing the logic of efficient governance to completion are examined and followed by concluding remarks.


*Keywords:* Transaction cost economics; Governance

The research program on which I and others have been working has been variously described as the "economics of governance," the "economics of organization," and "transaction cost economics." As discussed in section "An overview", governance is the overarching concept and transaction cost economics is the means by which to breathe operational content into governance and organization. The specific issue that drew me into this research project was the puzzle posed by Ronald Coase in 1937: What efficiency factors determine when a firm produces a good or service to its own needs rather than outsource? As described in section "The Vertical Integration of Production", my 1971 paper on "The Vertical Integration of Production" made headway with this issue and invited follow-on research that would eventually come to be referred to as transaction cost economics. The rudiments of transaction cost economics are set out in section "The rudiments". Puzzles and challenges that arose and would require "pushing the logic of efficient governance to completion" are examined briefly in section "Pushing the logic to completion". Concluding remarks follow.

## An overview

For economists, if not more generally, governance and organization are important if and as these are made susceptible to analysis. As described here, breathing operational content into the concept of governance would entail examining economic organization through the lens of contract (rather than the neoclassical lens of choice), recognizing that this was an interdisciplinary project where economics and organization theory (and, later, aspects of the law) were joined, and introducing hitherto neglected transaction costs into the analysis. A predictive theory of economic organization was the object. The puzzle of vertical integration was an obvious place to start.

### *Governance*

Whereas textbook micro-economic theory was silent on the concept of good governance, John R. Commons, who was a leading institutional economist during the first half of the 20th century, formulated the problem of economic organization as follows: "The ultimate unit of activity . . . must contain in itself the three principles of conflict, mutuality, and order. This unit is a transaction" (Commons 1932, p. 4). Commons thereafter recommended that "theories of economics center on transactions and working rules, on problems of organization, and on the . . .

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[1] This paper has benefited from my presentation of an early draft to my colleagues and students at the University of California, Berkeley and from subsequent discussions with Steven Tadelis. I have grave doubts that I would have undertaken the project described herein but for (1) my interdisciplinary training at Carnegie (where economics and organization theory were joined), (2) my experience as Special Economic Assistant to the Head of the Antitrust Division at the U.S. Department of Justice (which revealed the need within the antitrust enforcement agencies to bring economics and organization theory together), and (3) the opportunity to work these issues through with my students at the University of Pennsylvania when I resumed teaching. (Teaching is learning, especially if the students buy into the project.)

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[ways] the organization of activity is . . . stabilized" (1950, p. 21).

This conception of economics is to be contrasted with the neoclassical resource allocation paradigm in two important respects: first, whereas Commons viewed organization and the continuity of contractual relations as important, the resource allocation paradigm made negligible provision for either but focused instead on prices and output, supply and demand; second, whereas the price theoretic approach to economics would become the "dominant paradigm" during the 20th century (Reder 1999, p. 43), institutional economics was mainly relegated to the history of thought because it failed to advance a positive research agenda that was replete with predictions and empirical testing (Stigler in Kitch 1983, p. 170). Stalwarts notwithstanding, institutional economics "ran itself into the sand."

This does not imply, however, that institutional economics was lacking for good ideas. Indeed, the Commons Triple of conflict, mutuality, and order prefigures the concept of governance as herein employed – in that governance is the means by which to infuse order, thereby to mitigate conflict and realize mutual gain. Furthermore, the transaction is made the basic unit of analysis.

James Buchanan subsequently distinguished between lens of choice and lens of contract approaches to economic organization and argued that economics as a discipline went "wrong" in its preoccupation with the science of choice and the optimization apparatus associated therewith (1975, p. 225). If "mutuality of advantage from voluntary exchange is . . . the most fundamental of all understandings in economics" (Buchanan 2001, p. 29), then the lens of contract approach is an under-used perspective.

The past 35 years have witnessed growing interest in the use of the lens of contract, to include both theories that emphasize ex ante incentive alignment (agency theory/mechanism-design, team theory, property rights theory) and those for which the ex post governance of contractual relations is where the main analytical action resides. Transaction cost economics is an ex post governance construction, with emphasis on those transactions to which Commons called attention – namely those for which continuity (or breakdown) of the exchange relation is of special importance. How did the attributes of such transactions differ from the ideal transaction, in both law and economics, of simple market exchange (where no such continuity relation was implied)? What were the governance ramifications?

Answers to these queries would entail reformulating the problem of economic organization in comparative contractual terms by (1) naming the key attributes with respect to which transactions differ, (2) describing the clusters of attributes that define alternative modes of governance (of which markets and hierarchies are two), (3) joining these parts by appealing to the efficient alignment hypothesis, wherein (4) predictions would be derived to which empirical tests would be applied and (5) public policy ramifications would be worked up. Antecedent to the foregoing, the contact-relevant attributes of human actors would be named and explicated.

### *Organization*

Whereas the neoclassical theory of the firm treated the firm as a black box for transforming inputs into outputs according to the laws of technology, this was not, as Harold Demsetz observed, an all-purpose construction. It is a "mistake to confuse the firm of [neoclassical] economic theory with its real-world namesake. The chief mission of neoclassical economics is to understand how the price system coordinates the use of resources, not the inner workings of real firms" (1983, p. 377).

Although Demsetz did not make the case that economics and organization theory should be joined in a combined effort to understand firm and market organization of a real world kind, that is nevertheless the research need and opportunity as I perceived it – in no small measure because of my training (1960–1963) in the PhD program at Graduate School of Industrial Administration, Carnegie Mellon University. This remarkable program in interdisciplinary social science made the case that organization theory should both inform and be informed by economics.[2] Herbert Simon, James March, and Richard Cyert played especially important roles[3] in putting this across. Considerations of bounded rationality, the specification of goals,[4] intertemporal regularities (wherein organization takes on "a life of its own"), the critical importance of adaptation, the reliance within the operating parts on routines, and, more generally, the "architecture of complexity" were all basic concepts that would prove to be pertinent to an understanding of incomplete contracting and complex organization. Had the governance of contractual relations come under study at Carnegie, there is no question that this would have been examined in an interdisciplinary way.

### *Transaction costs*

Ronald Coase, in his classic 1937 paper on "The Nature of the Firm," was the first to bring the concept of transaction costs to bear on the study of firm and market organization. The youthful Coase (then 27 years old) uncovered a serious lapse in the accepted textbook theory of firm and market organization. Upon viewing firm and market as "alternative methods of coordinating production" (1937, p. 388), Coase observed that the decision to use one mode rather than the other should not be taken as given (as was the prevailing practice) but should be derived.

[2] Jacques Dreze speaks for me, and, I am sure, for many others in his statement that "Never since [my visit to Carnegie] have I experienced such intellectual excitement" (1995, p. 123). Nobel Laureates in economics from the small group of faculty and students at Carnegie include Herbert Simon, Franco Modigliani, Merton Miller, Robert Lucas, Edward Prescott, and Finn Kydland.

[3] Classic books by Carnegie faculty that feature economics and organization theory include Models of Man (Simon 1957b), Organizations (March and Simon 1958), and the Behavioral Theory of the Firm (Cyert and March 1963).

[4] One way to introduce organizational considerations is to change the objective function of the firm by supplanting the neoclassical assumption of profit maximization with various forms of "managerial discretion" – such as sales maximization (Baumol 1959), growth maximization (Marris 1964), or expense preference (Williamson 1964). These efforts to introduce "realism in motivation" yielded few predictions and resulted in little empirical testing.