

Management Course III- Transaction Costs Model

Dr. Manuel Angel (Coco) Morales

The transaction-cost approach emerged out of the field of economics. The model is based on the work of Oliver Williamson, *Markets and Hierarchies: Analysis and Anti-trust Implications*, and William G. Ouchi, *The Relationship between Organizational Structure and Organizational Control*. The aim of this model is to provide an explanation of the existence and operations of organizations.

The focus of this model is the transaction or exchange of goods and services. The premise is that individuals will act on their own self-interests, following the tradition of the rational man. Simple transactions happen in “on-the-spot” situations and are conducted in the free market-place. Over time, simple markets were replaced by more complex and uncertain situations. The environment or the market in which transactions took place became increasingly complex, and trust relationships were not enough to articulate business agreements; thus they became problematic and controversial. One key consequence of this kind of dynamics was the emergence of hierarchies or organizations.

Professor Oliver Williamson takes a turn away from the route favored by most economists. By focusing on the cost of transactions, rather than production, he introduces a new factor into the economics and sociology of organizations.

His main argument is that the typical neoclassical economic model conceived the firm as a system for managing production functions with primary decisions focused on the optimal mix of production factors, such as resources, labor and capital. In this classical model, variations in organizational design and management structure are thought as largely irrelevant. **By contrast, the transaction cost model poses that not the production but the exchange of goods and services is critical, and it emphasizes the importance of the design or the structure that governs these exchanges.**

The point is that for the transaction-cost model, effectively designed organizations are the response to uncertain environments and turbulent markets. Included in these environments are potential exchange partners whose trustworthiness is unknown and who might behave in an opportunistic way.

Bringing transactions under the hierarchy of the organization allows monitoring of behavior through direct supervision, auditing and other control mechanism.

Behaviors come under the context of the employment contract (a kind of economic and psychological incentive and the contribution to be deployed) dynamics.

Transactions costs are thus reduced or at least well managed by the presence of authority (a kind of command over decision-making processes). The logic here is that organizations would seek continuous growth of control through formation of trust and monopolies. Whenever this happens government should step in with anti-trust regulations and policies to enhance the effectiveness of the free market.

It is also possible for organizations to go back to market arrangements as it is done with outsourcing, temporary help, and sub-contracting. As **Lindberg, Campbell and Hollingsworth** point in their excellent piece *Economic Governance and the Analysis of Structural Change in the American Economy*, there is not a necessary one-way movement toward organizations from markets!

The transaction-cost approach has raised the consciousness level of sociologists of organizations. To give an example, **Robert G. Eccles and C. White Harrison** in *Price and Authority in Inter-Profiter Center Transactions*, note that there are transaction costs within firms, which may actually exceed the costs of external transactions. The organizational proposition and the word of alertness is that under certain conditions overhead changes can exceed the direct costs of programs, projects or initiatives.

A statement of prevention is whenever there is an effort to introduce free enterprise designs or devices in the form of market and competition, designers have to be alert at the presence or intrusion of bureaucratic traditional management systems that may oppose to the emergent and more democratic free to choose systems. Also, designers have to be aware that economic and organizational transactions are ALWAYS embedded in complex social relations. An example is that in modern societies economic transactions are related to the quality of the relationships. This interaction is very, very interesting because as my longtime professor William Glasser instructed us, relationships first and then business transactions!

As it is the case for all models, the transaction-cost perspective, even acknowledging that costs are economic and social, is best used in combination with other explanation or frameworks. In a way transaction-costs are interaction processes between organizations and their environments, networks and markets. These interactions can be structured

and then turned to the transaction processes themselves. Among the many design mechanism available to leaders and managers, the most frequently used are the following:

1. Interaction formalization (create a formal process)
2. Interaction standardization (creates and performs to common standard)
3. Establish a system of interaction priorities
4. Structure the frequency of interaction
5. Induce reciprocity (an empirical symmetry of the transaction)
6. Nourish a power base to influence and / or determine the result of the transaction.
7. Cooperation or collaboration as pursuing own goals and at the same time orienting actions to common purpose or outcome
8. Induce conflict to block activities of another party, acknowledging that this has anticipated and none anticipated consequences.
9. Establish conflict resolution systems to reduce costs of transactions
10. Coordination (concerted decision-making or action)

Regardless of whether transactions are mainly social, economic or a combination, and whether they are individually, collectively or hierarchically managed, the transaction-cost model is necessary to understand and lead organizations.

Dr. Manuel Angel (Coco) Morales

Contact Freelance at: cocomorales1@gmail.com

Cell phone: 787- 249-6102