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Transaction cost economics in Scandinavian business administration

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Abstract

This Introduction briefly surveys transaction cost economics and explains its general relevance for business administration. A discussion of the impact of transaction cost economics on Scandinavian work in business administration is offered, after which the contributions to the present Special Issue are introduced.

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1. Introduction

For almost three decades, and building in particular on the work of Oliver E. Williamson, transaction cost economics (henceforth, “TCE”) has been a very prominent voice in the conversation in the central fields in business administration, notably in strategy, organization, and marketing. The corporate governance field, and to a lesser extent the human resource management field also bear the imprint of TCE. Few issues of top journals such as the *Academy of Management Review*, *Academy of Management Journal*, *Journal of Marketing*, *Strategic Management Journal*, etc. are published without at least one paper mentioning and perhaps using TCE.

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Scandinavian (and European) business administration may not (yet) exhibit similar penetration by TCE.¹ Yet, and this may come as a surprise to many readers of the present journal, the Scandinavian countries, particularly Denmark (Copenhagen Business School) and Norway (Norwegian School of Economics and Business Administration (NHH) and Norwegian School of Management (BI)), are strongholds of TCE in business administration in the European context (Foss & Foss, 2003). Important contributions have been made by Scandinavian scholars in the fields of strategy, organization and, particularly, marketing.

This Special Issue is offered as a confirmation of the status of TCE as an established voice in Scandinavian business administration, as a showcase for some interesting current research, and as a possible stimulus for further Scandinavian TCE-based research in business administration. There is no claim here for the existence of a distinct “Scandinavian approach” in TCE,² only that there is much interesting work to which this issue may hopefully provide an entry point.

The present Special Issue is based on a workshop, “Nordic Workshop on Transaction Cost Economics in Business Administration,” that was organized at the Norwegian School of Economics and Business Administration (NHH), Bergen, 20–21 June 2003, by Professor Sven Haugland and Associate Professor Svein Ulset, both of NHH, and the editor of this special issue. I am grateful to my colleagues, Sven and Svein, for the dedication and effort that they put into the process of organizing this workshop and to NHH and the Institute for Research in Economics and Business Administration (SNF) for generous financial support. The organizers were proud that Oliver E. Williamson agreed to participate and deliver a keynote speech. The editor of this special issue is particularly proud that Professor Williamson agreed to have his speech included here. On a basis of this workshop, about a dozen papers were selected for potential inclusion in this Special Issue. Those that made it through the review process are printed below.

The remainder of this Introduction first provides a brief overview of TCE and explains its general relevance to diverse fields in business administration. This is followed by a brief discussion and mapping of TCE in Scandinavia, and a brief survey of the papers included below.

2. Transaction cost economics: what is it? How is it relevant?

2.1. Coase

As Oliver Williamson emphasizes in his contribution to the present Special Issue, there is a significant business administration dimension to the origin of the TCE

¹The names of James March (115), Michael Porter (81), Henry Mintzberg (80), Herbert Simon (63), and James Thompson (55) all trump Williamson’s (26) in terms of frequency of citation in the pages of *Scandinavian Journal of Management*, but Williamson is cited as frequently as Jay Barney and more often than Michael Jensen (22).

²Although it is arguable that such a claim could be made for Scandinavian (mainly Norwegian) TCE work in industrial marketing and inter-firm relations.

enterprise. Indeed, Ronald H. Coase—the originator of the modern theory of the firm—was a student of commerce rather than economics and, as he recounts in a retrospective contribution (Coase, 1991), his main early influence was the London School of Economics business administration professor, Arnold Plant. In particular, Plant’s quoting of Arthur Salter’s dictum that “the normal economic system works itself” stimulated Coase’s curiosity: The Salter view seemed to “... leave obscure the role of business management and of the employer–employee relationship,” Coase (1991, p. 39) later recounted. This curiosity, as is well known, led to the writing of the now classical paper, “The Nature of the Firm” (Coase, 1937). As Williamson (2005) notes, that paper was “... the first and arguably the most important of [Coase’s] challenges to orthodoxy. Coase’s training in business administration and field work on vertical integration contributed to his skepticism with orthodox treatments of firm and market organization.”

It is not surprising that “The Nature of the Firm” has achieved the status of a true classic. It is written in a simple, engaging way, and makes its important point with effortless ease. More importantly, many—perhaps most—of the major themes of the modern theory of the firm are clearly stated in this paper. For example, Coase argues clearly for the centrality in the economics of organization of, in the contemporary parlance, incomplete contracts and transaction costs (“the costs of using the price mechanism”), and he argues in favor of a basic contractual conceptualization of the firm and an efficiency approach to its explanation. Most importantly, he defines the main tasks of a theory of the firm, namely to “discover why a firm emerges at all in a specialized exchange economy” (i.e. the *existence* of the firm), to “study the forces which determine the size of the firm” (i.e., the *boundaries* of the firm) and to inquire into, for example, “diminishing returns to management” (i.e., the *internal organization* of the firm).

In following the program thus sketched, and certainly also in addressing the puzzles that Coase had left—notably the nature of the determinants of “the costs of using the price mechanism”—, most of the modern theory of the firm certainly deserves to be called Coasian. However, for a number of reasons (notably the heavy concentration on the competitive equilibrium model in economics), Coase’s seminal analysis was neglected for more than three decades in the sense that, although its existence was known and acknowledged, it was not *used* (Coase, 1972).³ For a long time, it did not give rise to a cumulative theory development.

To use Williamson’s terms (Williamson, 1985), Coase’s analysis still awaited its basic “operationalization.” Thus, Coase (1937) had listed several sources of those “costs of using the price mechanism” that give rise to the firm. These include the costs of negotiating and writing contracts. A second type of cost is that of executing separate contracts for each of the manifold market transactions that would be necessary to coordinate a particular complex production activity. But Coase had given virtually no details on the determinants of these costs. It was clear, particularly after the publication of Coase (1960) that they were somehow connected to defective

³It may be questioned how well it really was known. For example, Marschak (1965) writing in *The Handbook of Organizations* about “Economic Theories of Organization” does not even mention Coase.

knowledge and with the issues relating to the definition and enforcement of property rights, but apart from that relatively little was known.

2.2. *Williamson*

Prompted in part by breakthroughs in property rights economics and the economics of information and uncertainty, work that made use of transaction cost notions began to blossom in the mid-1970s. At the time of Coase's lamentation that his 1937 paper had been "much cited and little used," serious work on the theory of firm had begun to take off, notably [Williamson's \(1971\)](#) paper "The Vertical Integration of Production: Market Failure Considerations" and, a year later, [Alchian and Demsetz's paper \(1972\)](#), "Production, Information Costs, and Economic Organization." These two papers gave rise to different streams of research, of which the Williamsonian one will be considered here.

Since his contributions in the 1970s Williamson has in a string of influential contributions built an impressive edifice (see in particular the summarizing trilogy, [Williamson, 1975, 1985, 1996a](#), which, albeit built on a Coasian foundation, also incorporate ideas from cognitive psychology, and organization theory of the Carnegie–Mellon variety (on the Carnegie connection, see [Williamson, 1996b](#)). It may be described as an extension and refinement of the Coasian research program that has proceeded by defining the proper unit of analysis and how it can be dimensionalized; identifying the behavioral assumptions that are necessary to produce non-trivial problems of economic organization; linking contracts with the wider governance apparatus in which they are embodied; clarifying how transactions with given characteristics are organized by governance structures with different organizational capacities (assuming that efficiency is the driving force behind this alignment); and expanding the set of "economic institutions of capitalism" that are susceptible to economic analysis. These points are briefly considered below.

2.3. *Transaction cost economics in a nutshell*

The micro-analytic approach of TCE lies in its taking the transaction, that is, a transfer of a good or a service across a technologically separable interface, as the basic unit of analysis and its examination of the economizing efforts that attend the organization of this. While economizing efforts are always required, they may be variously complicated, depending on the attributes of the transactions. These attributes are captured in the three dimensions of uncertainty, frequency and asset specificity, in an important step towards operationalizing the "... costs that attend completing transactions by one institutional mode rather than another" ([Williamson, 1975](#), pp. 1–2). While all three dimensions are taken into account, asset specificity has increasingly become the central character in Williamson's story, because—unlike frequency and uncertainty that can always be handled by contractual means—it is the factor that gives rise to contractual hazards. "The main factor to which transaction-cost economics appeals to explain vertical integration," Williamson argues, "is asset specificity" ([Williamson, 1986](#), p. 189).

Thus, the prediction is that the choice between contractual forms and governance structures will primarily reflect asset specificity, because both are means for handling the contractual hazards that asset specificity may introduce.

Transactions take place between agents that are characterized in the cognitive and motivational dimensions in ways that differ from standard economics. Thus, the behavioral starting-points in Williamson's theorizing are, first, Herbert Simon's notion of *bounded rationality*, which introduces contractual incompleteness and a need for adaptive, sequential decision-making. Second, there is *opportunism*, which is defined as "self-interest seeking with guile," a notion that harks back to Williamson's work in the 1960s on the managerial theory of the firm (Williamson, 1964). The implication of opportunism is that contracts will often require various types of safeguards, such as "hostages" (e.g., the posting of a bond with the other party to a transaction) or various kinds of legal machinery. Williamson's term for contracts and the safeguards they embody is "governance structures," of which three main categories—markets, hybrids, and hierarchies—are identified (Williamson, 1991). The basic idea is then that transactions are assigned to alternative governance structures on the basis of their transaction properties (how they "score" in terms of uncertainty, frequency and asset specificity). Specifically, "[t]he main case hypothesis out of which TCE is this: align transactions (which differ in their attributes) with governance structures (which differ in their costs and competencies) in a discriminating (mainly transaction cost economizing) way" (Williamson, 1996a,b, pp. 46–47).

This logic is most dramatically worked out for the case when assets are highly specific. Specific assets open the door to opportunism. If contracts are incomplete due to bounded rationality, they must be renegotiated as uncertainty unfolds. And if a party to the contract (say, a supplier firm) has incurred sunk costs in developing specific assets (including human capital), that other party can opportunistically appropriate an undue part of the investment's pay-off ("quasi-rents") by threatening to withdraw from the relationship. This situation leads to a Pareto-inferior outcome, for example, a no-trade outcome. Fear of "hold up" ex post will affect investment choices ex ante. In the absence of appropriate contractual safeguards, the transacting parties may choose less specific—and therefore less specialized and less productive—technology. If, on the contrary, the transacting parties were to pool their capital into a single enterprise in whose profits they jointly shared, the incentives for unproductive rent-seeking would be attenuated. However, there is more to integration, Williamson argues, than concentrating ownership rights: authority partakes of an important role as arbitrator in the face of conflicts and disputes over unforeseen contingencies, and there is a qualitative and quantitative differences between the information structures that are available under market contracting and those that are available in the firm.⁴

⁴These arguments differentiate TCE from the property rights approach of Hart (1995) and his colleagues and students.

2.4. Transaction cost economics in business administration

Given that TCE was developed in the context of economics, that it was—at least until the end of the 1970s—pretty much a one-man enterprise, and that its first major contribution is Williamson's (1975) book, *Markets and Hierarchies*, business administration scholars were remarkably quick to adopt TCE notions. Examples of early adopters are Erin Anderson (Anderson, 1985; Anderson & Schmittlein, 1984) in marketing (in turn, an important influence on Scandinavian adopters of TCE), William Ouchi (1980) in organization, David Teece in strategy and innovation management (e.g., Teece, 1980a, b, 1984, 1986), and Richard Rumelt in strategy (e.g., Rumelt, 1984), all of whom were quick to adopt basic TCE tenets and to use them actively in their work. Moreover, a number of these scholars promoted the new approach in influential programmatic statements (such as Rumelt, 1984; Teece, 1984; Rumelt, Schendel, & Teece, 1994). The result, more than two decades later, is that "... transaction cost economics (TCE) has become one of the leading perspectives in the study of management and organization" (David & Han, 2004, p. 39).⁵

The motives for adopting TCE in business administration probably lie in a combination of an economizing perspective, clear predictions, and considerable success with respect to the corroboration of those predictions (Shelanski & Klein, 1995; David & Han, 2004), and the interdisciplinary stance inherent in TCE from its inception. Thus, TCE's economizing perspective on economic organization provided a fresh perspective in industrial marketing, naturally aligned with earlier contingency theories in organization theory, and harmonized with the strong economics influence in strategic management. TCE scored predictive successes early on (e.g., Teece, 1980a). As regards inter-disciplinarity, this was arguably a strong motivating reason for the relative success of TCE in at least the strategy field: As Rumelt, Schendel, and Teece (1994, p. 28) noted, "[w]ithin strategic management, transaction cost economics is the ground where economic thinking, strategy, and organizational theory meet."⁶

3. Transaction cost economics in Scandinavian business administration

3.1. The Norwegian School of Economics and Business Administration

TCE became a significant voice in Scandinavian business administration in the 1980s. Perhaps the first adopter, and still one of the most influential Scandinavian contributors to TCE, was Torger Reve.⁷ With a 1980 Ph.D. from Northwestern and papers in *Academy of Management Review* and *Journal of Marketing* (Reve & Stern,

⁵This is not to say that TCE was enthusiastically embraced, in general; on the contrary, it met with fierce opposition in many quarters (Perrow, 1986; Donaldsson, 1995) and continues to be regarded as controversial (e.g., Ghoshal & Moran, 1996).

⁶This has also allowed a number of the proponents of TCE to have dual careers, that is, within both business administration and economics.

⁷Arguably, Stern and Reve (1980) is the first paper that applies TCE in a marketing context.

1979; Stern & Reve, 1980), Reve returned to a research professorship at the Norwegian School of Economics and Business Administration (NHH) in Bergen. Although by no means an orthodox TCE scholar (see, e.g., Kalleberg & Reve, 1992), Reve nonetheless relied heavily on TCE in his mainly marketing-oriented work. This feature, combined with his insistence on the systematic use of rigorous empirical methods, equipped Reve with a novel (at least in a Scandinavian context) and clearly identifiable approach that quickly gained many adherents, primarily among Ph.D. students. Among the latter were Sven A. Haugland, Arne Nygaard, Svein Ulset, Arnt Buvik and Aksel Rokkan, who have all continued to apply TCE systematically in their business administration (primarily marketing) research.

Scandinavian research in TCE was without doubt at its strongest at NHH at the end of the 1980s. NHH was then truly the center of TCE research in Scandinavia, not just in industrial marketing, but also in strategy (e.g., Reve, 1990) and project management (Kolltveit & Reeve, 1998). To the extent that it makes any sense to speak of a distinct Scandinavian voice in TCE, this would be because of the clear focus of Reve and his co-workers and students on inter-organizational relations and success with which this focus was made visible internationally (in addition to the Grønhaug and Haugland and, Buvik and Haugland papers in this issue, examples include Ulset, 1996; Haugland, 1999; Haugland & Ness, 2004; Buvik, 2002; Buvik & Reve, 2002; Dahlstrom & Nygaard, 1999).

A spinoff of this focus was the formation of the still-existing Nordic Workshop on Interorganizational Relations, a workshop series that—although it was mainly organized for the discussion of the research of doctoral students—always managed to stimulate discussion between invited faculty of the merits and drawbacks of TCE. In particular, the Workshop generated often heated discussions between proponents of TCE and proponents of the network approach of Håkan Håkansson, Jan Johansson, and Lars-Gunnar Mattson and others.⁸

3.2. *Copenhagen Business School*

The other Scandinavian center for research in TCE in business administration has been the Copenhagen Business School.⁹ TCE-based research took off somewhat later at CBS and has remained much less focused in terms of subject fields than the TCE-based research at the The Norwegian School of Economics and Business Administration. The lead in promoting TCE at the Copenhagen Business School was taken by Christian Knudsen, whose main interest was economic methodology, primarily as applied to various theories of the firm, among them TCE (see Knudsen, 1991). However, Knudsen organized a group at CBS, “The Research Group for New Theories of the Firm,” which albeit rather short-lived had a distinct TCE focus, thus

⁸Foss and Koch (1996) is a critique of this approach from the perspective of TCE. Johansson and Mattson (1987) is an early comparison of the two perspectives.

⁹Oliver Williamson spent a sabbatical at the CBS organization department in 1974. However, this did apparently not impact the research agenda of that department. Williamson received an honorary doctorate from CBS in 2000. He also holds an honorary doctorate from the Norwegian School of Economics and Business Administration (1986).

placing TCE firmly on the research agenda of CBS. Around the end of the 1980s, a cohort of Ph.D. students who were interested in the application of TCE to business administration emerged. These students included Steen Thomsen, Ricky Wilke, Bent Petersen, Kirsten Foss, Torben Pedersen, and the editor of the present Special Issue.

Compared to the focused research efforts that characterized the Reve students in Norway, the Danes were a much more diverse lot who went on to apply TCE to issues in international business (e.g. Benito, Pedersen, & Petersen, 2004), industrial marketing (e.g., Wilke & Philipsen, 2001), firm growth and change (e.g., Thomsen, 1992), corporate governance (e.g., Thomsen & Pedersen, 2000), the internal organization of firms (e.g., Foss, 2003b), strategy (e.g., Foss, 2003a), and innovation issues (e.g., Kirsten Foss, 1996).¹⁰

3.3. *Other efforts*

Another vehicle for the spread of TCE ideas was a series of workshops on organization theory that was initiated in 1980. James March, James Thompson and Oliver Williamson put in appearances. Torger Reve recalls that “I think at that time nobody really took an interest in what Williamson said, except I. I absorbed every word he said.”¹¹ A later related development was a major conference in Uppsala which resulted in the publication of Aoki, Gustafsson, and Williamson (1990).

At the end of the 1990s, TCE also made an impact on the major Danish research unit, Danish Research Unit of Industrial Dynamics. Numerous Williamson students and other adherents of TCE have thus presented work at the annual DRUID conferences. The 1998 conference was devoted to the issue “competence and governance perspectives on the firm,” and Oliver Williamson delivered the keynote address at this conference. A number of papers from the conference were later published in Foss and Mahnke (2000).

Many other Scandinavian academics apart from those based at NHH and CBS have published work that applies TCE to business administration, for example, Lindkvist (1993), Koch (1994), Collin (1997), Benito (1996), and Nilsson (2001). In addition, a third generation of Scandinavian scholars who apply TCE to business administration is emerging (e.g., Ness, 2001; Hammervoll, 2003; Tomassen, 2004). All in all, a reasonable estimate of the number of Scandinavian academics who actively apply TCE in business administration is probably around fifty (see Foss & Foss, 2003 for the Danish and Swedish situation). For the majority of these, however, TCE does not hold a particularly privileged status. It is one out of a number of useful perspectives alongside the resource-based view of the firm, the capabilities approach, the network view, etc.

¹⁰Recent relatively focused CBS efforts have included “The Danish Corporate Governance Network,” the “Law, Economics and Finance Center,” the “Learning, Incentives and Knowledge Program” (<http://www.cbs.dk/link>) and the “Center for Knowledge Governance” (<http://www.cbs.dk/ckg>), all of which are partly based on TCE as an important input into research activities. Numerous TCE scholars have visited CBS, invited by these research centers. The role of the CBS-based Danish Research Unit for Industrial Dynamics has already been mentioned.

¹¹Personal communication, 27 September 2004.

4. This special issue

The present special issue opens with a paper by Oliver Williamson, “Transaction Cost Economics and Business Administration.” In tracing the long relationship between these two, Williamson discusses how Coase was influenced not only by his business education but also by observing real business practices. He explains how Chester Barnard—executive and management thinker extraordinaire—anticipated many of the key positions that have come to be associated with TCE, and touches on later developments associated with Herbert Simon, James March and Richard Cyert. After offering a number of instructive examples of how TCE goes “beyond proximate reasoning to examine incomplete contracting in its entirety,” with significant implications for business practice, Williamson examines the citation performance of TCE, adding to earlier studies by, for example, [Shelanski and Klein \(1995\)](#) and [Boerner and Macher \(2001\)](#). He first provides figures for his own and Coase’s citations, noting that “[t]he growth in business citations has been especially noteworthy.” Thus, almost 40% of Williamson citations are now “business citations.” A breakdown of the citation figures reveals that strategy research is the major user of TCE. Although these are relatively crude numbers, they arguably capture the overall trend well.

The remaining four papers all in various ways extend the TCE logic by drawing on ideas about reputations and credible commitments in the context of long-lived relations, dynamic transaction costs and capabilities, network externalities, and human resource management.

Arnt Buvik and Sven A. Haugland’s article “Allocation of Specific Assets, Relationship Duration, and Contractual Coordination in Buyer–Seller Relationships” is directly within the Norwegian tradition of applying TCE to interfirm relations. The main contribution of their article is to examine the linkage between the allocation of asset specificity and the use of contractual coordination, exploring specifically whether this linkage is contingent upon the prior length of the relationship. In particular, they hypothesize that as a relationship evolves over time, credible commitments in conjunction with a balanced dependence structure relaxes the need for specific safeguarding devices. This hypothesis is corroborated.

Kjell Grønhaug and Sven A. Haugland’s article, “A Transaction Cost Approach to a Paradox in International Marketing,” begins with a puzzle: Why do firms that make downstream specific investments as they start international operations sometimes turn to more market-like arrangements as they gain international experience and their international sales increase? The authors note that this finding appears to contradict the influential Uppsala internationalization model. Relying on a mixture of TCE arguments and ideas from capabilities theories, the authors argue that vertical disintegration in the context of internationalization can often be understood in terms of the emergence of external capabilities that become superior relative to the capabilities controlled by the firm, prompting the spin-off of hitherto internally organized functions as the transaction costs of using the market decline. The argument is developed with reference to the Norwegian farmed salmon industry.

Øystein D. Fjeldstad and Erik W. Jakobsen's article, "Transaction Organizations and Transaction Cost Analysis: A Theoretical Investigation of the Domain Expansion Decisions in Firms Employing a Mediating Technology" is an innovative application of ideas drawn from Thompson (1967) and work on network externalities to TCE. From Thompson comes the notion of mediator firms that link clients or customers who wish to be in some way interdependent. This relates directly to the notion of network externality, since mediating firms can be seen as orchestrating networks and the positive externalities that these may yield. The contribution to TCE here is to propose and develop the notion of "network specificity," and to explore how the attendant hazards help explain the scope decisions of mediators and their decisions about the integration of network segments.

Finally, Gabriel R.G. Benito, Sverre Tomassen, Jaime Bonache-Pérez, and José Pla-Barber's article, "A Transaction Cost Analysis of Staffing Decisions in International Operations," applies TCE to a field where it has been a very infrequent visitor, namely the (international) human resource management field. They start from the central problem in this field of whether to select expatriate or local personnel to manage and work in foreign subsidiaries. Noting that selecting local personnel is often the cheaper recruitment option, they ask, why in a business context defined by the need to cut costs, do multinational companies continue to make extensive use of international assignments? The authors venture to provide an answer based on TCE, specifically the TCE analysis of the ex post transaction costs of the employment relation. They propose that the monitoring, bonding, maladaptation and bargaining costs of using expatriates are lower than those generated by local employees, especially in the higher managerial echelons of the foreign subsidiary. The resulting model and the hypotheses it yields are empirically corroborated by survey data on a sample of 145 Norwegian MNCs.

5. Conclusions

The application of TCE to business administration issues is in healthy shape in the Scandinavian countries. From humble beginnings in the 1980s, the number of academics who actively use TCE in their research has been steadily increasing. Scandinavian business academics who apply TCE are well published. Thus, work has been published in *Strategic Management Journal*, *Organization Science*, *Journal of International Business Studies*, *Journal of Marketing Research*, *Journal of Economic Behavior and Organization*, as well as in other high-ranking journals. Although it does not make sense to speak of a distinct Scandinavian approach to TCE, Scandinavian TCE researchers do appear to have one distinguishing feature as eclecticists who creatively combine TCE with other approaches in order to address hitherto unexamined issues. The papers in this Special Issue exemplify this quality. There is reason to expect that TCE will continue to be a success story in Scandinavia. The present Special Issue is offered both as a showcase for existing research and as a stimulus to further research in this area.

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