

Lecture X: Williamson – Chapter 1

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Outline

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Introduction
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Cognitive Map
The World of Contract
A Simple Contracting Schema

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Transaction Costs – Explication

Cognitive Map

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Readings for next time

- ▶ Williamson, O.E. 1985. *The Economic Institutions of Capitalism*, Free Press – Chapters 2 and 3.

Introduction

- ▶ Williamson follows some of the same ground we discussed in Coase and Grossman and Hart – Specifically, a large portion of microeconomics treats the firm as a Black Box.
 - ▶ In fact, most anomalies in markets such as sales regions are treated as monopolies under market failure.
- ▶ The main proposition that Williamson will develop throughout this book is that economic institutions (i.e., firms) are organized in an attempt to economize on transaction costs.

- ▶ "The underlying viewpoint that informs comparative study of issues of economic organization is this: Transaction costs are economized by assigning transactions (which differ in their attributes) to governance structures (the adaptive capacities and associated costs of which differ) in a discriminating way."
- ▶ Essentially changes in transaction costs imply differences in governance structures.
- ▶ Maybe also to the point that changes in technology may imply changes in transaction costs which could then lead to changes in governance structure – the emergence of internet marketing firms such as Amazon have lead to changes in the structure of retailing firms – the demise of some retailers such as Sears, Target, etc.

Transaction Costs

- ▶ "Kenneth Arrow has defined transaction costs as the 'costs of running the economic systems.'"
- ▶ Essentially, economists like to think about transaction costs as frictions.
 - ▶ Suppose that I want to buy a monitor for my personal laptop.
 - ▶ The first transaction cost is a search cost.

- ▶ What local stores carry monitors?
- ▶ What kind of monitors do they have and which one fits my needs?
- ▶ What about online merchants?
- ▶ What about shipping?

- ▶ How do I pay for the monitor? – Cash you got to be kidding, Debit card. What about guarantee on the transaction?
- ▶ Do I get a warranty? Or now days, what does a warranty cost?

- ▶ As discussed in the text, physics started off like economics assuming that friction was low (or even zero).
 - ▶ However, their analysis was tempered by empirical verification of their facts in experiments.
 - ▶ Unfortunately, economists have really not exposed many of our conjectures to the same rigorous verification. This has allowed us to ignore frictions with the same level of sophistication of other science.

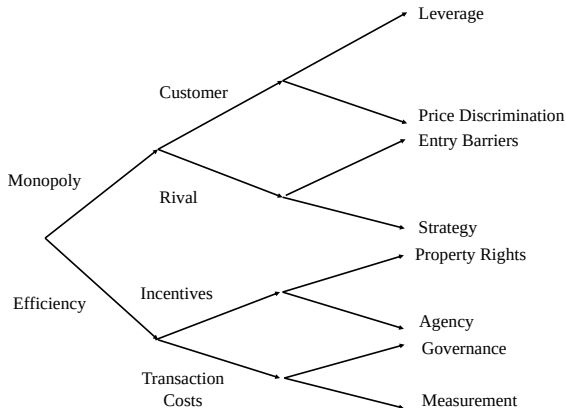
- ▶ "The neglect of transaction costs had numerous ramifications, not the least of which was the way in which nonstandard modes of economic organization were interpreted."
 - ▶ "Until express provision for transaction costs was made, the possibility that nonstandard modes of organization – customer and territorial restrictions, tie-ins, block booking, franchising, vertical integration, and the like – operate in the service of transaction costs economizing was little appreciated."
 - ▶ "Instead, most economists invoked monopoly explanations – be it of the leverage, the price discrimination, or entry barriers kind – when confronted with nonstandard contracting practises."

Transaction Costs – Explication

- ▶ Transaction costs include both *ex ante* costs such as search and contracting costs, and *ex post* costs such as the cost involved in the enforcement of a contract.
- ▶ The *ex post* enforcement costs bear a little discussion.
- ▶ There are two general approaches to enforcement costs – economic and legal.
- ▶ "Most studies of exchange assume that efficacious rules of law regarding contract disputes are in place and are applied by the courts in an informed and sophisticated, and low cost way."
- ▶ This is a "legal centralism" construct. In fact reliance on courts can be very expensive. It may be more profitable (i.e., less costly) to simply write off the loss rather than resort to courts.

- ▶ Economically, the best recourse is a self-enforcing contract – one in which it is each agent's best interest to live up to the terms of the contract.
 - ▶ For example, it could include a buy-out clause in the case of a bad outcome.
 - ▶ In the Grossman and Hart model the pricing transfer agreement was self-enforcing.

Cognitive Map



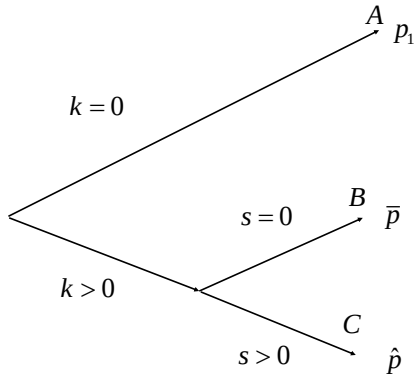
- ▶ Transaction costs are typically identified with the efficiency branch
- ▶ "The property rights literature emphasizes that *ownership matters*, where the rights of ownership of an asset take three parts:
 1. the right to use the asset,
 2. the right to appropriate returns from the asset, and
 3. the right to change the form of the asset."

- ▶ Related to the property rights venue is the agency cost as we developed under Jensen and Meckling.
- ▶ "In common with the property rights literature, transaction costs economics agrees that ownership matters. It furthermore acknowledges that *ex ante* incentive alignment matter."
 - ▶ "But whereas the property rights and mechanism design approaches work within the traditional legal centralism, transaction cost economics disputes that court ordering is efficacious."
 - ▶ "'James Buchanan has argued that 'economics comes closer to being a 'science of control' than a 'science of choice' [on which account] the maximizer must be replaced by the arbitrator, the outsider who tries to work out compromises among conflicting claims.'"

The World of Contract

Behavioral Assumption		Asset Specificity	Implied Contracting Process
Bounded Rationality	Opportunism		
0	+	+	Planning
+	0	+	Promise
+	+	0	Competition
+	+	+	Governance

A Simple Contracting Schema



- ▶ k is the level of transaction specific assets.
 - ▶ If $k = 0$ the breakeven price (market price) is p_1 .
 - ▶ If $k > 0$ the price depends on the possibility of safeguards s .

► Summary of nodes:

1. Transactions that are efficiently supported by general purpose assets ($k = 0$) are located at node A and do not need protective governance.
2. Transactions that involve significant investments of a transaction specific kind ($k > 0$) are ones for which the parties are effectively engaged in bilateral trade.
3. Transactions located at node B enjoy no safeguards ($s = 0$), on which account the projected breakeven supply price is great ($\bar{p} > \hat{p}$).
4. Transactions located at node C incorporate safeguards ($s > 0$) and thus are protected against expropriation hazards.
5. Inasmuch as price and governance are linked, parties to a contract should not expect to have their cake (low price) and eat it too (no safeguard).