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Transaction Cost Economics & the Organization of Economic Activity

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Abstract

This project involves a review of the Transaction Cost Theory and its ability to effectively explain the organization of economic activity. Based on the works of Ronald Coase and, in particular, the works of Oliver Williamson, the foundations of this theory and its predictions about the governance structure of economic transactions are studied. Following this review, the cases of two companies are analyzed in order to evaluate the theory´s ability to explain the decision of internalizing specific activities. The outcome of the theory´s empirical application showcased its ability to effectively explicate the internalization of activities whose transaction costs are lower within the boundaries of the firm, while highlighting its limitations in situations where the decision to internalize activities is mainly motivated by strategic factors or limited by financial factors.

Word Count: 11,850
Keywords: outsourcing, vertical integration, emprical application, asset specificity

Resumen

Este trabajo consiste en una revisión de la Teoría de Costes de Transacción y su capacidad para explicar la organización de las actividades económicas. A partir de los trabajos de Ronald Coase y, fundamentalmente, de Oliver Williamson se describen los fundamentos básicos de esta teoría y sus predicciones sobre la estructura de gobierno de las transacciones económicas. Posteriormente, se analizan los casos de dos empresas con el fin de comprobar la capacidad de esta teoría, así como sus limitaciones para explicar la decisión de integrar ciertas actividades dentro de los límites de la empresa. Los resultados ponen de manifiesto su capacidad para explicar la integración de actividades desde un punto de vista económico. Sin embargo cuando en las decisiones de integración existen motivos de naturaleza estratégica o financiera, la teoría exhibe su limitación.

Número de Palabras: 11,850
Palabras clave: subcontratación, integración vertical, aplicación empírica, activos específicos

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Introduction

The development of the Transaction Cost Theory has greatly influenced the understanding of the organization of economic activity – the classic dichotomy between markets and hierarchy as forms of organization – and, as a result, has also impacted the understanding of economic systems´ behavior. Markets are not always the most effective mechanism of coordinating exchanges when there are certain costs that generate frictions in the implementation of the price mechanism. These costs are known as *transaction costs* and are the very core of this theory.

As transaction costs rise, and consequently the cost of using the price mechanism increases, transactions will tend to be coordinated through other more efficient organization alternatives – alternatives that reduce transaction costs. The main alternative to the price mechanism is coordinating the exchange within the firm; this implies that the activity is integrated within the boundaries of the firm. As stated by Williamson, “the study of transaction cost economizing is thus a comparative institutional undertaking which recognizes that there are a variety of distinguishably different transactions on the one hand and a variety of alternative governance structures on the other” (1981b, p. 1544). With these concepts in mind, the Transaction Cost Theory´s main objective is to construct an analytical guideline that sanctions the assessment of which factors determine the magnitude and volume of transaction costs and their influence on the decision to use one organization mechanism over its alternatives. The Transaction Cost Theory becomes, therefore, an extension of the theory of the firm and indicates that firms exist because they are a more efficient organizational alternative to manage certain transactions. This greater efficiency is consistent of a well-working interface that minimizes almost completely any frictions.

The decision to focus the dissertation on this area of study was made taking into account that many firms reconfigure their portfolio of activities in order to be more efficient by either integrating new activities or contracting other activities through the market and that the Transaction Cost Theory explains these organizational phenomena to a certain degree. Consequently, this dissertation is composed of two levels of study - theoretical and empirical.

The theoretical part consists of an in depth review of the Transaction Cost Theory: its origins, its foundations, applications and main limitations. From a methodological perspective, the theoretical analysis is primarily based on the works of Ronald Coase and Oliver Williamson.

The empirical approach consists in studying the cases of two companies who have decided to internalize certain activities within their boundaries. The methodology of field research was applied to the practical section of this paper. The first case study consisted of a glassworks firm located in Coruña that has integrated an activity previously coordinated through the market. An interview with the owner was conducted in order to gain insight as to the nature of firm, its activities as well as the factors that influenced the decision to integrate the subcontracted activity. This information facilitates the application of the Transaction Cost Theory conducive towards the analysis and comprehension of why one organizational alternative was preferable to another. The second case study selected was a U.K.-based start-up company whose main activity consists of renting luxury vacation homes in London and New York City. The new alternative to vacation lodging is a rising trend in the hospitality industry and, given its possible effect on the future of tourism, piqued a certain level of interest as to its method of organization. Due to its novelty, the company is reluctant to share major details as to its internal organization, decision-making criteria and certain operational details since it presents major differences with comparable competitors in the market, thus all information about this company hails from the information published on their corporate website and publications regarding the company. In spite of this, there is enough information to analyze the decision of internalizing the activity of home services. Unlike the first case, this activity was not originally coordinated through the market.

1. Transaction Cost Economics: Theoretical Foundations

1.1 The Transaction Cost Approach and Its Antecedents

Classic economic theory proposes that the firm´s main function is to produce a good with the objective to maximize profits. This proposition is viewed to be lacking in the ability to explain the organizational phenomena of the existence of firms and why certain activities are integrated within their boundaries. There have been many other approaches to the study of organizations proposed, such as managerial discretion theory, agency theory and the transaction cost approach. This paper will focus on the transaction cost approach and the works of its main contributors: Ronald Coase and Oliver E. Williamson.

“The transaction cost approach to the study of economic organization regards the transaction[1] as the basic unit of analysis and holds that an understanding of transaction cost economizing is central to the study of organizations” (Williamson, 1981a, p. 548). Although this approach is not able to address all organizational issues, it is capable of explaining many situations by using the transaction costs as the main unit of analysis as well as evaluating the governance structures and their ability to minimize transaction costs.

The transaction cost approach is applied at three levels of analysis: the firm and its organizational design; the operating units, the activities performed within the firm, the activities performed outside the firms and the reasoning behind these decisions; and the organization of the human assets (Williamson, 1981a, p. 549). In as much, this approach is strongly correlated to economic literature, organizational theory literature and contract law literature due to its connection with governance matters.

Despite basing the foundations of the transaction cost approach and transaction cost economics on the findings of Coase, it should be noted that the antecedents are not limited to his works. Although Coase will be studied in the

[1] According to Williamson, a transaction occurs when a good or service is transferred across a technologically separable interface (1981a, p. 552).

upcoming section, some contributors to the advancement of the transaction cost approach should be mentioned.

Among the first advocates of using transactions as the units of analysis is John R. Commons in 1934. He acknowledged the variety of governance structures to organize exchanges and viewed that the choice in governance structure according to the ability to harmonize said exchanges was a focal point in the study of institutional economics. Another individual who provided further support to the transaction cost approach, albeit indirectly, is Friedrich Hayek, who highlighted the importance of efficient adaptation in high performance economy in his article “The Use of Knowledge in Society” (1945). Decades later, Herbert Simon contributed to the theory recognizing the limits of human actors, which are central behavioral assumptions behind Williamson´s development of the Transaction Cost Theory (TCT).

A deepening awareness of transaction cost issues formed over decades and the importance of transaction cost economizing grew. The following subsections will review the contributions of Coase and Williamson.

1.2 Coase and the Theory of the Firm

Ronald Coase´s “The Nature of the Firm” elaborates the discovery and clarification of the significance of transaction costs, as well as other variables, for the institutional structure and functioning of the economy. These observations are considered to have established the field of transaction cost economics. In the previously cited essay, Coase suggests examining foundations upon which a theory is built, prior to developing a theory, in order to avoid assumptions, which may cause misunderstanding or controversy (1937, p.18). On this note, it seems prudent to commence the study of transaction cost economics with the very article upon which the field was founded.

In his essay, Coase attempts to understand why firms emerge in addition to the evolution of their size. Ronald Coase´s approach stems from the following contemplation: If the market is as effective in the coordination of economic exchanges as neo-classical theory makes it out to be, why aren´t all transactions managed through the market? In other words, why are certain exchanges carried out within the boundaries of the firm whereas others are not?

Based on these ideas, Coase points out that there are two alternative methods of coordinating production: price mechanisms and the entrepreneur or coordinator (1937, p. 19). If production is truly regulated by the price mechanism, the question as to why there is any organization at all emerges.

As an answer to the previous question, Coase offers the following reasons: individuals prefer a work relationship instead of being dependent on the price mechanism, commodities produced by firms are favored by purchasers, and the cost of using the price mechanism is superior to the cost of organizing the activity through the firm (1937, p. 20-21).

Despite having mentioned the previous reasons, Coase negates the importance of the first two. The desire of a relationship over price mechanism implies that an individual “A” wants to work under the direction of “B”; this goes against the more common human desire of wanting to be one´s own master. In any case, the desire of the relationship should be viewed from the angle of “B” wanting to exercise control over his subordinate “A”. This would mean that “B” pays his subordinate more than the price mechanism so he can control him. This line of reasoning, however, implies that “B” is not getting paid which is untrue and illogical in reality. In reference to the second reason cited, the purchasers´ preference of commodities produced by firms, Coase comments that even if such a preference existed its importance would be negligible in the real world.

The cost of using the price mechanism seems to be the driving force behind the emergence of the firm. The cost of “organizing” production through the price mechanism consists of the process of discovering what the relevant market prices are. This cost is reduced but not eliminated when specialists sell this information. It must be noted that the costs of negotiating and concluding separate contracts for each transaction carried out on the market are greatly reduced when there is a firm. This is due to the fact that when there is a firm, the series of contracts needed to organize transactions through the market is substituted by only one contract.

At this point it seems convenient to properly define the term *contract*. Coase outlines the term as an agreement “whereby the factor, for a certain remuneration (which may be fixed or fluctuating), agrees to obey the directions of an entrepreneur within certain limits" (1937, p. 21). Furthermore, Coase highlights that the essence of the contract is that it should only state the limits to the powers of the entrepreneur so that he can direct other factors of production within stated limits.

In regards to the contract, one must take into account that it may be desired to make a long-term contract for the supply of some article or service in order to avoid the cost of making or renewing several shorter term contracts. The decision to make a long-term contract in lieu of a short-term contract is influenced by the risk attitude of the agents involved as well as the uncertainty involved in foreseeing the future, which makes it very difficult to conjure a detailed contract as to the expectations of the other contracting party. The necessity to exact the details of the relationship at a later date causes a relationship to develop, which Coase terms a "firm" (1937, p. 21). In other words, a firm is likely to emerge in cases where a long-term contract would be satisfactory.

The cost of using the price mechanism is clearly supported by Coase as the reason as the main reason of why firms exist. Previously, the cost of using the price mechanism was limited to the cost of discovering the relevant prices. This must be expanded to include other less obvious factors, such as the pressure on the entrepreneur to keep costs below market prices, uncertainty and differential treatment of operations (1937, p. 22). These additional factors, however, would merely bring about the existence of firms if they did not exist already due to other motives.

The first of these factors is an expansion of the idea that carrying out a transaction within a firm is done so because of reduced costs. The entrepreneur who coordinates that transaction must keep in mind that if he fails to obtain factors of production at a lower price than in the market, it is always possible to revert to the open market. Under the pressure of losing the transaction, the entrepreneur is careful to fulfill the expectations upon him.

Second of all, uncertainty is considered to be a relevant variable in the study of equilibrium of the firm. Without uncertainty there is a high improbability that firms would emerge since the knowledge of the market is absolute.

The topic of differential treatment previously mentioned refers to the manner in which governments or other institutions consider transactions organized in the market and those same transactions organized through the firm. An example of this factor would be operations sales tax. This tax is applied to transactions carried out through the price mechanism, but operations organized through the firm are not subject to this tax. In this case, transactions coordinated by an entrepreneur receive preferential treatment thus eliciting the presence of firms, which would not exist in other scenarios.

With all of these notions in mind, it can be said that the firm consists of the system of relationships that derives from the management of resources´ dependence on an entrepreneur. Logically, the size of the firm varies in accordance with the number of transactions coordinated by the entrepreneur. According to Coase (1937, p. 24), the firm tends to be larger, assuming that all else remains static, in the following cases:

- When the costs of organizing are low and when said costs rise slower than the increase in the transactions organized
- When it is unlikely that the entrepreneur misallocates the resources or when the increase in mistakes is lower than the increase in the transactions organized
- The larger the reduction in the supply price of factors of production to larger firms.

When discussing the size of the firm it is critical to take into account the influence of diminishing returns as the firm´s size increases as well as the importance of correctly allocating factors to where they generate the most value. Additionally, larger firms may face the difficulty of rising supply prices, which benefits small independent firms (Coase, 1937, p. 23). The efficiency of a firm is another variable to take into account when studying the firm and its size. It is highly probable that as the dimension of the firm escalates, the efficiency with which it organizes its transactions diminishes.

In addition to the previous disadvantages of larger firms, there are higher costs of organizing and the losses derived from misallocation of resources will increase as the transactions are carried out from a distance, when said transactions vary greatly and when there is a probability that relevant prices will change. When contemplating the distance, it is important to note that inventions, technological advancements and all kinds of improvements will lessen the disadvantages of a growth and aid in the continued growth of the firm (Coase, 1937, p. 25).

Lastly, it should be noted that the growth of a firm might occur in two directions, which are not mutually exclusive -- lateral growth or vertical growth. Lateral integration, also denominated “combination”, consists of one entrepreneur organizing transactions previously coordinated by two or more entrepreneurs. Contrarily, vertical integration consists of the firm absorbing the organization of a transaction that was previously organized in the market.

Having reasoned why firms emerge and the factors that influence their size, Coase criticizes previously accepted theories as to why firms exist. These ideas are that firms emerge due to the complexity caused by the elevated differentiation resulting from the division of labor and that the presence of uncertainty necessitates the existence of a firm.

Coase refutes the first argument, which is supported by Maurice Dobb, that firms emerge due to the division of labor under the premise that the price mechanism acts as the “integrating force” that prevents the chaos caused by increased differentiation. Also, specialization does not always lead to “chaos” and, therefore, Dobb´s argument is unacceptable.

In a very summarized statement, Knight claims that without the presence of uncertainty in a system there is entrepreneur who is in charge of coordinating production but in a routine manner, which lacks true responsibility, and that the introduction of uncertainty, the main concern of the entrepreneur is “deciding what to do and how to do it” (1937, p. 27). Coase disparages this first part of Professor Knight´s theory questioning the presence of entrepreneurs without responsibilities in a system without uncertainty – Who is paying them and for what reason? Why is the price mechanism superseded by the figure of a coordinator? All of these questions being valid queries as to the existence of these coordinators if their presence is superfluous. Coase further criticizes Professor Knight´s argument that due to the uncertainty of human nature, it would be unusual for one man to be able to assure another individual of a guaranteed result without the direction of the latter. In other words, if a consultant[2] enters a contract with an entrepreneur, it would be highly unusual for the consultant to be able to assure the entrepreneur of a guaranteed result if he is not under the entrepreneur´s direction. It is an unreasonable supposition that a person of superior judgment, who is contracted because of this advantage, should be under the direction of an individual who lacks these qualities. Typically, consultants are allowed independence in order to fulfill their tasks and obtain the desired results.

In reference to the theories behind the size of firms, Coase invalidates the assumption that a firm´s growth is limited, under perfect competition, if its cost curve slopes upwards or, under imperfect competition, it will not pay to produce more than the output at which marginal cost is equal to marginal revenue by pointing out that the assumption is based on the idea that firms only produce one product, however, a firm is capable of producing several problems. Taking this last detail into account, the previous "cost-curve theory of the firm" is deemed impractical (1937, p. 28).

Concluding his essay, Coase verifies whether or not the concept of the firm depicted throughout the article corresponds with the reality of the firm. The concept does, in fact, match the essence of the legal concept of firm, which is the "employer-employee" relationship. In this latter model, the employee´s (also denominated agent) freedom to carry out his employment is a distinguishing characteristic.

Previous to Coase´s contribution to the study of organizational economics, classical and neo-classical theory dictated that an economy could be coordinated by the price mechanism and together with the definition of the conditions necessary for this type of structure, these observations would be known as the theory of the firm. While the aforementioned theory explained the structure and operations of markets it lacked the ability to explain the existence of firms. Coase´s great insight into this query is that firms exist due to the fact

[2] Professor Knight points out that individuals with superior judgment or superior knowledge exist and that they are able to obtain an income by marketing these qualities as business consultants. This income or reward would be obtained by making contracts with the people in charge of production.

that sometimes the cost of managing economic exchanges within the boundaries of the firm are inferior to the cost of managing these same transactions across markets. Hence, transaction costs were placed at the center of the study in the pursuit to expound the existence of firms and the idea that markets and firms were alternative forms of coordinating economic activity (Barney & Hesterly, 1996, p. 116).

1.3 Williamson and the Development of the Transaction Cost Theory

Despite contributing an innovative perspective of organizational economics, Coase´s “The Nature of the Firm” lacked influence until decades later, when Oliver E. Williamson continued the development of the economics of transaction costs. The main deficiency behind Coase´s ponderings is his failure to operationalize his approach as well as the lack of precision in delineating which transactions will be left to the market and which are internalized by the firm (Barney & Hesterly, 1996, p. 116). When referring to the failure of operationalizing his approach, it should be mentioned that according to Coase´s approach governance form matters only to the extent that transaction costs prevent individuals from reaching and enforcing mutually beneficial bargains and the nature or size of these costs differ between organizational forms. “In a world of zero transaction costs, individuals would always negotiate to realize all potential gains from trade or cooperation regardless of organizational forms” (Barney & Hesterly, 1996, p. 116).

The influence of Coase´s discernment grew once Williamson, in addition to other economists, operationalized the concept of transaction cost. According to Williamson´s reasoning, in order to operationalize Coase´s approach “it is necessary to identify the critical features distinguishing governance alternatives, assess the differential capacities and limitations of those alternatives in relation to attributes of transactions and match governance structures and transactions “in a discriminating way” thereby allowing predictions relating transaction attributes and organizational form to be formulated and tested” (Masten, 2010). Due to his extensive study of transaction costs and correction of its deficiencies, Williamson´s works are now considered to be the basis of transaction cost economics.

A fundamental contention of Williamson´s Transaction Cost Theory (TCT) is that markets and hierarchies are alternative governance mechanisms for completing a set of transactions. The former of these alternatives tends to rely on prices, competition and contracts to keep all parties of an exchange informed of their rights and responsibilities where as the latter governance alternative relies on the presence of an authoritive third party known as “the boss”. “The boss” has the right to resolve any conflicts that might emerge; Williamson terms this right as *managerial fiat* (Barney & Hesterly, 1996**,** p. 117).

1.3.1 Behavioral Assumptions

In accordance with his intention of correcting previous theory flaws, Williamson departs from the traditional assumptions of established in the foundations of neoclassical economics: omniscient hyperrationality and costless contract enforcement. Williamson submits a “more self-conscious attention to `human nature as we know it´” (1981a, p. 553). The TCT substitutes the previous postulations about economic actors involved in exchanges with the concepts of bounded rationality and opportunism. “As a consequence of these two assumptions, the human agents that populate the firms and markets with which I am concerned differ from “economic man” (or at least the common caricature thereof) in that they are less competent in calculation and less trustworthy and reliable in action” (Williamson, 1981b, p. 1545).[3]

Omniscient hyperrationality implies the absence of cognitive limits. Under such conditions, all exchanges could be conducted through planning. Individuals could devise contracts of unlimited complexity that would specify all possible eventualities in an economic exchange. Omniscient third parties capable of ideally planning and directing economic activity or of resolving disagreements between agents accurately and cheaply do not exist since all individuals suffer bounded rationality.

[3] This departure from “economic man” introduces, what Williamson terms as “organization man” (1981a, p. 553).

Bounded rationality refers the fact that, although individuals intend to act in a rational manner, their ability to carry out those intentions are hindered by their limited knowledge, foresight and computational ability. These limitations make individuals unable to solve complex problems instantaneously, anticipate all future contingencies or reliably plan and communicate appropriate responses to the eventualities they do foresee. Limited competence does not, however, imply irrationality since they remain “intendedly rational” (Williamson, 1981a, p. 553).

The substitution of omniscient hyperrationality with bounded rationality, the first of Williamson´s behavioral assumptions, annuls the possibility of complex contracting due to the uncertainty factor. As a consequence, the best that can be achieved is incomplete contracting (1981a, p. 554).

The second of Williamson´s behavioral assumptions is opportunism. This assumption substituted the postulation of costless contract enforcement and that economic actors behave out of self-interest. Williamson´s TCT implies that “opportunism effectively extends the usual assumption of self-interest seeking to make allowance for self-interest seeking with guile” (1981b, p. 1545). Opportunism includes lying, stealing, and cheating but, in a general sense, encompasses the incomplete or distorted release of information, especially with the objective of misleading, distorting, and confusing partners in the exchange. It should be noted that the TCT does not state that opportunism is always observed in economic actors, it merely contemplates the possibility of its presence. Because of this, the threat of opportunism and the necessity to identify opportunistic actors becomes a cost to be assumed in the transaction.

Without the threat of opportunism, exchanges could easily be carried out on the basis of a promise; there would be no reason to distrust the participants in the exchange. Since this is not a realistic approach and there are many individuals prone to opportunism, safeguards to prevent opportunistic actions must be designed to protect individuals and firms. Thus, the previously referenced incomplete contracting is the best type of contract that can be achieved when there is opportunistic behavior. The cost of distinguishing opportunistic agents from non-opportunistic agents ex ante is very costly (Williamson, 1981a, p. 554).

Although these behavioral stipulations complicate the study of economic comportment and may be unneeded for some purposes, the study of alternative modes of organization does not qualify as an exception (Williamson, 1981b, p. 1545-46). With these behavioral stipulations defined, the TCT dictates that the choice of governance depends on the form of governance (market or hierarchy) that reduces any potential problems created by bounded rationality and by the threat of opportunism. Williamson focuses on the need "to assess alternative governance structures in terms of their capacities to economize on bounded rationality while simultaneously safeguarding transactions against opportunism" which merely shifts, not eliminates, the attention from the emphasis on profit maximization (1981b, p. 1546).

Market forms of governance tend to be less costly than hierarchal governance because of lower fixed costs. Therefore, so long as the market alternative enables all parties of an exchange to reduce potential problems caused by bounded rationality and opportunistic actions, market governance will be preferred to hierarchal governance. In the case that the market is unable to resolve these problems, a hierarchal governance form will be adopted despite being a more costly option (Barney & Hesterly, 1996, p. 117). To synthesize this reasoning, if the main objective is to minimize cost then market governance will be chosen. However, if the main concern is to minimize the effects of bounded rationality and opportunism, then a hierarchal form of governance where a third party resolves problems that arise due to behavioral factors is selected.

1.3.2 Transaction Attributes

As stated above, bounded rationality and opportunism are at the core of problems for the economic actors participating in the transactions. Attributes of transactions that are of particular interest to the economics of organization and are critical to their description are the degree to which transaction requires transaction-specific investments (also known as asset specificity), uncertainty, and transaction frequency. The analysis of the uncertainty and asset specificity dimensions is based on the assumption of recurrent transactions (high frequency).

A. Asset Specificity

The most important dimension for describing transaction, and the previously most neglected attribute in prior organizational theory studies, is asset specificity and the level of specific transaction investment (Williamson, 1981a, p. 555). Oftentimes, in order to carry out a transaction, parties will need to make investments to be able to complete the exchange. The level of specificity greatly influences opportunistic actions on behalf of the actors since a transaction specific investment usually points towards a quasi-bilateral exchange relation between buyer and seller for a considerable period thereafter (1981b, p. 1546). For example, if a machine is purchased exclusively to carry out an activity and cannot be used to carry out other transactions, it is a highly specific investment for the supplier and can lead to the other party taking advantage of this. The other party can demand a better price knowing that if they back out of the deal then the supplier has no use for that machine. On the other hand, if the supplier were to buy a machine that has multiple uses and can be of value to various transactions, the risk of opportunistic behavior would be minimized.[4]

Despite the possibility of opportunistic behavior, both parties are significantly “locked into” the transaction. The supplier has made a highly specific investment in order to serve the client, which implies a high level of commitment on his behalf. Meanwhile, the buyer cannot turn to alternative suppliers, assuming that they have not made the same specific investment, since the cost of supply from an unspecialized source is great (1981a, p. 555).

An investment that is very specific suggests that the investment does not have value for other transactions and can provoke nonmarketability problems in the case of costly specific investments, which are known as idiosyncratic transactions. These are transactions of high specificity possessing important cost-bearing consequences. Idiosyncratic exchanges include specialized physical capital as well as human capital investments that are transaction specific. In recurrent idiosyncratic transactions, additional transaction-specific savings in communication stemming from familiarity may accrue, as contracts

[4] This example does not rule out possible opportunistic behavior of the supplier. A supplier´s opportunistic behavior can be minimized in situations where the buyer can turn to alternative sources to obtain the desired good or service.

are adapted to the unfolding events and are periodically renewed. As the contract renewals take place, a specialized language permitting a more efficient communication between supplier and buyer develops. Additionally, the transaction becomes more personal due to a strengthened trust between the agents, which consequently reduces opportunistic behavior. Given these concepts, assuming all other factors pertaining to the relationship are equal, idiosyncratic transaction relations featuring personal trust will survive greater stress and be more adaptable (Williamson, 1979, p. 240-241).

Asset specificity can present itself in several forms: site specificity, physical asset specificity, human asset specificity and dedicated assets (Williamson, 1983, p. 526).

- Site specificity: occurs when an agent locates their facilities next to the other in order to economize on transportation cost. For example, building the distribution facility next to the production plant.
- Physical asset specificity: involves investments in equipment, such as machinery, specially designed to serve a particular customer.
- Human asset specificity: arises when at least one of the agents develops valuable skills or knowledge specific to that transaction or relationship.
- Dedicated assets: are investments made to support exchange with a particular customer that, though not specific to that customer, would result in considerable excess capacity were the customer to discontinue the relationship.

The greater the level of transaction specific investments in an exchange, the greater the threat of opportunism and, thus, the more likely it would be to choose a hierarchal form of governance. Based on these ponderings, Williamson answers Coase´s original query of “why do firms exist?”. His response is that firms (referred to as “hierarchy” by Williamson) exist in order to resolve that problems of market governance with transaction specific investments under the conditions of uncertainty. Transaction specific investments and uncertainty add a level of complexity that market governance cannot manage effectively. Once these complex transactions are managed under common directives, the management and resolution of the problems is facilitated by several factors: more effective communication, common processes and a lack of disputes due to the convergence of expectations of the parties acting in the transaction.

Even though hierarchal governance is beneficial in certain scenarios, like everything it has its limits and disadvantages. Firms are faced with incentive and bureaucratic deficiencies that limit their size; markets are able to offer high-powered incentives, which are very difficult to replicate in hierarchies, especially those larger in size (Barney & Hesterly, 1996, p. 119).

B. Uncertainty

Uncertainty is a major problem related to bounded rationality. “Without uncertainty, bounded rationality is irrelevant” (Barney & Hesterly, 1996, p. 117). It would not be realistic for parties of an economic transaction to be able to foresee how the transaction will evolve over time as well the rights and responsibilities that change and be able to manage said transaction. A contract that foresees the future and contemplates every possible outcome is unimaginable in the face of uncertainty. A high level of uncertainty, particularly in the case of a high level of asset specificity, usually implies a greater difficulty to use market governances such as contracts. Hence, it would be more likely, and convenient, to apply a hierarchal form of governance where it is agreed that a third party will mediate and resolve problems as they arise.

In the case of transactions with high uncertainty and a medium level of non-specificity, there are two options: standardize the product by sacrificing design qualities thus enabling the application of market governance or preserving the design and devising a more elaborate arbitration apparatus (bilateral governance). Bilateral governance would eventually shift towards integration of the activity as uncertainty increases for recurrent transactions (Williamson, 1979, p. 254).

A transaction´s grade of uncertainty evolves as the industry matures. The greater an industry´s maturity, the lesser a transaction´s uncertainty and the less it will be integrated within the firm. Thus, the transactions will rely on market governance.

C. Transaction frequency

Frequency refers to the recurrence of the transaction and can be separated into three categories – one-time, occasional and recurrent. The frequency of a transaction is often linked with asset specificity or investments given that a transaction´s frequency would greatly influence the outcome of an investment decision (Williamson, 1979, p. 246). *Figure 1* illustrates examples of commercial transactions according to buyer frequency and characteristics of a supplier´s investment. *Figure 1* disregards one-time transactions as very few transactions possess this isolated characteristic. The six examples of transaction types are shown in the matrix – purchasing standard equipment, purchasing standard material, purchasing customized equipment, purchasing customized equipment, constructing a plant and site-specific transfer of intermediate product across successive stages. Each transaction type should be matched with the corresponding type of governance structure.

According to *Figure 2* regarding matching governance structures with commercial transactions, the decision to integrate an activity within the boundaries of the firm occurs when the transaction is recurrent and idiosyncratic (unified governance, also termed internal organization). Only non-specific investments would de satisfactorily realized through market; all other transactions would be carried out according to a hierarchy structure or a hybrid form of governance. All other transaction types would correspond with a hybrid form that permits transaction cost economizing.

Each governance structure possesses its own advantages and disadvantages, but certain structures are better suited to transactions boasting of particular characteristics or attributes. The following subsection will detail the characteristics of the governance structures indicated in *Figure 2*.

		Investment Characteristics		
		Nonspecific	Mixed	Idiosyncratic
Frequency	Occasional	Purchasing Standard Equipment	Purchasing Customized Equipment	Constructing a Plant
	Recurrent	Purchasing Standard Material	Purchasing Customized Material	Site-Specific Transfer of Intermediate Product Across Successive Stages

Figure 1: Examples of commercial transactions according the frequency and degree of idiosyncrasy [5]

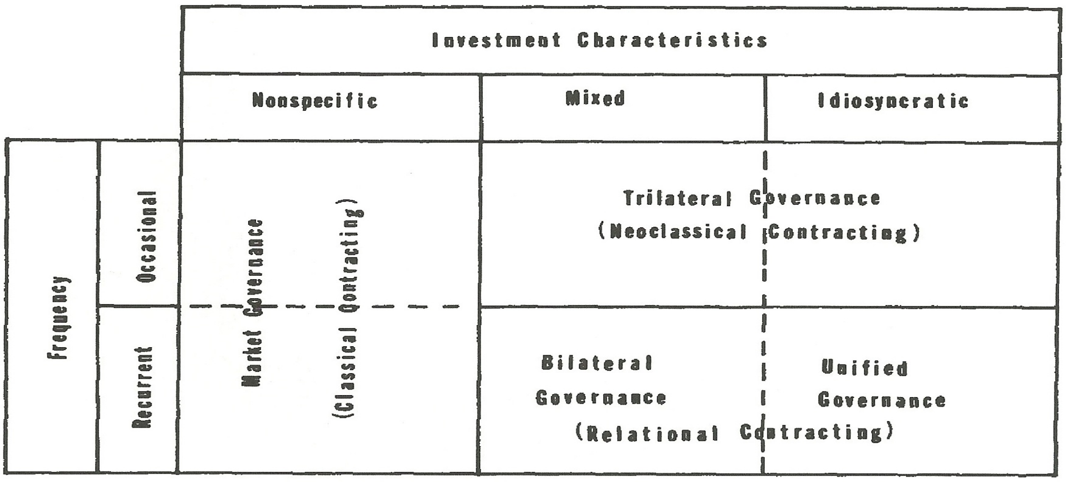

Figure 2: Matching Governance Structures with Commercial Transactions[6]

1.3.3 Governance Structures and Fundamental Transformation

In his 1979 article, Williamson classifies governance structures according to the investment specificity. The nonspecific governance structure refers to the market; contrarily, highly specific structures are carefully adapted to a particular transaction and are strongly influenced by identity, as is mentioned in the subsection regarding asset specificity. Semi-specific governance structures are alternative structures possessing qualities of market governance and

[5] Source: Williamson, O.E. (1979), "Transaction-Cost Economics: The Governance of Contractual Relations", Journal *of Law and Economics*. Vol. 22 No. 2, p. 247

[6] Source: Williamson, O.E. (1979), "Transaction-Cost Economics: The Governance of Contractual Relations", Journal *of Law and Economics*. Vol. 22 No. 2, p. 253

specialized structure. He also suggests several propositions:

- Highly standardized (nonspecific) transactions do not tend to require specialized governance structure.
- Only recurrent transactions will support a highly specialized governance structure.
- Occasional specific transactions will not support a transaction-specific governance structure, but require special attention regardless

With these propositions in mind, Williamson links transaction types with governance structures, categorizing the governance structures according to contract classification[7]; this relationship is illustrated in *Figure 3*. The details of each governance structure will be expounded according to ascending degree of transaction specificity.

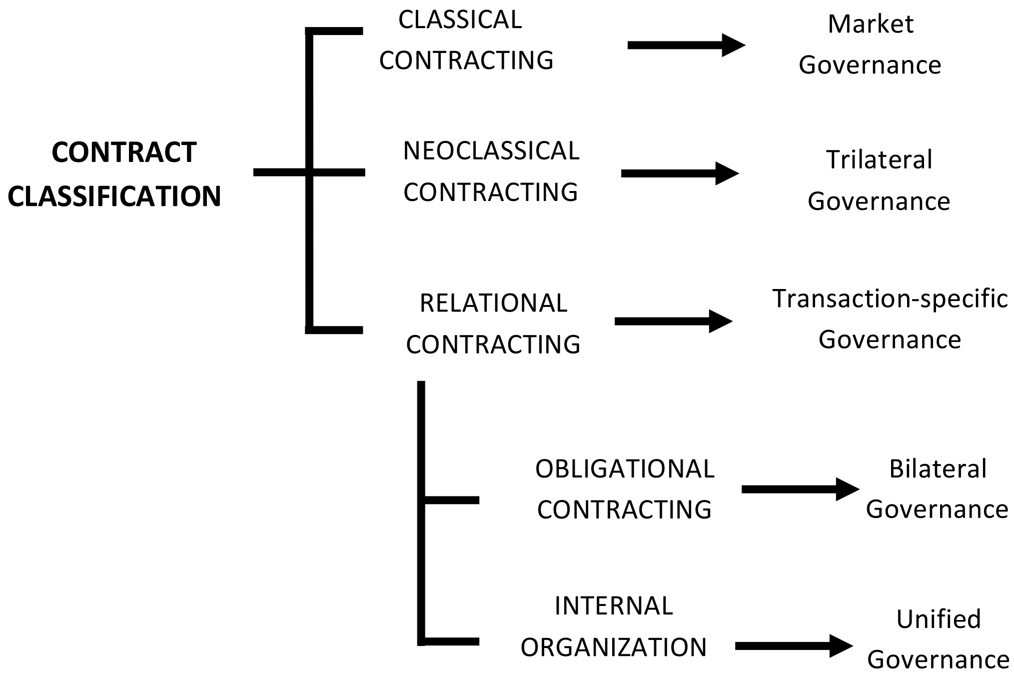

Figure 3: Relationship between contract classification and governance structure

[7] Williamson adopts Ian Macneil´s three-way classification, which recognizes classical, neoclassical and relational contracting. For a brief contracting background refer to Williamson´s article “Transaction-cost Economics: The Governance of Contractual Relations” (1979).

A. Market Governance

Most nonspecific transactions, regardless of their frequency[8], have a market structure as their main governance structure since the standardized characteristic of the transaction should be easily coordinated. This governance structure is particularly effective in recurrent transactions, as previous experience will dictate whether to continue the relationship or turn elsewhere at minimal expense. Occasional nonspecific transactions, however, do not allow buyers to rely on direct experience but rather permits the usage of others´ previous experience to influence the decision of continuing the partnership. In these cases, experience acts as a safeguard against opportunistic behavior.

This type of exchange would better correspond to the term sale and not to a contract. A contract would be employed in this governance structure in the absence of a standardized market. Additionally, given the lack of specificity, identity is irrelevant. There is no concern as to the sustenance of the relationship as there would be in more personal partnerships. Should there be any conflict between the parties, they would proceed towards litigation in order to settle the claims.

B. Trilateral Governance

Trilateral governance is applied in the cases of occasional transactions of mixed and high specificity. The principals of these transactions have strong incentives for completing their end of the deal once they enter into a contract due to the strong investments they have made in equipment, for example, in order to be able to satisfy the need of a particular client. The motivation to sustain the relationship is higher for idiosyncratic transactions.

The non-standardized characteristic of specific transactions makes market governance unsatisfactory, while the elevated cost of a transaction-specific governance structure is too costly. Hence, an intermediate form is needed, prompting the adoption of trilateral governance. This governance structure would turn to arbitration to resolve disputes and evaluate performance, in lieu of litigation and prior experience.

[8] As clarified in the subsection referring to a transaction´s frequency, one-time transactions are disregarded since the isolated characteristic of those exchanges are uncommon in typical transactions.

C. Transaction-specific Governance

Transaction-specific governance is applied in the cases of recurrent transactions of mixed and high specificity. As in trilateral governance, due to the specificity of the transaction, market governance is hazardous. Unlike trilateral governance, the frequency of the transaction makes the cost of a specialized governance structure recoverable.

Two types of transaction-specific governance structures are distinguished: bilateral governance and unified governance. Bilateral governance maintains the parties´ autonomy whereas unified governance removes the transaction from the market, internalizing said activity thus submitting it to the firm´s complete control. Unified governance is also known as vertical integration, which is one of the most studied applications of the TCT.

Bilateral governance is applied in recurrent transactions that possess a mixed degree of specificity. It is necessary to adopt unified governance when the transaction is idiosyncratic due to the investment in human and physical assets.

Due to the mixed specificity present in bilateral governance, components that are needed may be obtained from an outside source. In comparison with vertical integration, external procurement is beneficial to controlling costs, but is much less adaptable than vertical integration because of the dependence on an external agent that cannot be controlled. Adaptations to future eventualities are made through contract amendments as the eventualities take place; contemplating all eventualities is costly and impossible under the condition of bounded rationality. Additionally, opportunism is a hazard of adaptation that should be recognized and may be curbed by restricting adjustments to those that present the least threat of such behavior.

In reference to adaptations in bilateral governance structures, quantity adjustments seem to be a more effective solution than price adjustments. The parties involved are more likely to trust quantity adjustments than price adjustments since the latter raises suspicions that the other party is attempting to alter the terms within the bilateral monopoly arrangement in his favor. Price adjustments may be made in certain cases, but only when hazardous effects are minimal.

The parties involved in a transaction that applies bilateral governance will tend to sustain the partnership. The buyer will not attempt to find an alternate supplier since other sources will incur in higher setup costs and the idiosyncratic product is not as adaptable to other need or clients as a standardized product. Also, suppliers will not try to withhold the product supply because a better opportunity has arisen and a larger profit may be obtained.

The more idiosyncratic a transaction, the lesser the incentives for trading and the more it tends to be internalized as to take advantage of possible economies of scale. This would correspond with unified governance, which is present in vertical integration. A unified governance structure is very flexible as the organization of the activity is carried out within the firm and any changes can be made without consulting, completing or revising interfirm agreements. Highly idiosyncratic transactions, which are vertically integrated, are characterized by an extensive adaptability in both price and quantity.

1.3.4 Fundamental Transformation

Opportunistic tendencies where one of the agents may negotiate prices or walk away from a deal are irrelevant in situations where the identity of the agent is unimportant. As indicated in the subsection pertaining to asset specificity, in transactions with high specificity the recurrence becomes a key factor. Without the continuity of the relationship, the investing agent is forced to maintain a costly investment that may not have alternative uses. Once the identity of the agent is recognized and trust is built, opportunistic behaviors would be reduced. The notion of high physical or human capital specificity and the importance of exchange continuity are linked with the concept of fundamental transformation. Given the relationship specific assets, there may be a shift from operating in a competitive market (where the level of specificity is low) to a more monopolistic setting. Thus the way the transaction is considered varies, prompting a change in the governance structure in order to adapt (Williamson, 1979, 239-241). This process of adaptation of the governance structure to the characteristics of transaction given the dynamic nature of economic relationships is referred to as fundamental transformation.

Safeguards in the form of long term contracting become a necessity to eradicate the hesitancy of making such specific investments and the fear of appropriation. The long-term contracting is limited by bounded rationality and possible opportunistic behavior due to the factor of high uncertainty stemming from the expanded timeline. The resolve these impediments it would be crucial that the contract be devised anticipating a great deal of eventualities as well as outlining their resolution or determining a process of adaptation as the relationship evolves. This type of contracting is costly, very difficult and provokes opportunistic behavior, thus supporting the application for a different governance form.

1.3.5 Applications and Limitations

Even with its weaknesses, the TCT does an admirable job of rationalizing the existence of firms. The TCT has improved the understanding of governance choice and organizational theory; as such, it has numerous applications. The most direct application of the TCT is the topic of vertical integration.

Vertical integration, besides being the most direct application of the TCT, is also the most researched application. Coase referred to vertical integration within the framework of firm dimension and the value added from the absorbed transaction. The TCT approaches it from the perspective of “make or buy” decisions and reasons that transaction specific investment increases the likelihood that a transaction is internalized within the firm. This outcome is supported by a reiteration of the decision to internalize a transaction regardless of the type of transaction specific investment – capital intensity, human asset specificity or firm specific skills, site specificity, or small numbers bargaining. Unlike transaction specific investments, the effect of uncertainty on the decision to internalize an activity is erratic (Barney & Hesterly, 1996, p. 120). Additionally, Williamson furthers the study of forward integration by commenting on the influence of quality of a branded good or service on the decision to integrate an activity. In cases of differentiation where the quality of a product (and therefore the control of assuring that level of quality) is a major concern and a distributor´s level of compliance with standards cannot be verified, it may be in the brands´ interest to integrate this activity so that the product´s reputation is not maligned by subpar craftsmanship (1981b, p. 1549).

A second application of the TCT, which is of equal importance despite not being as researched, is in the field of organizational design. This extension of the TCT pertains to the internal organization of the firm and is manifested in the multidivisional form as well as the multinational enterprise.

Williamson asserts that bounded rationality and opportunism are the source of the implementation of the multidivisional form in large American firms (Barney & Hesterly, 1996, p. 120).[9] These firms are faced with bounded rationality due to basic human limitations as well as the difficulty of keeping track of the details of every transaction carried out (both internally and externally). The complexity of a functional form of organization makes it difficult to assign responsibility for successes and failures of a product or line of business. Also the threat of opportunism lurks over growing firms due to the diverging goals of the functional units and the firm as a whole. These problems are resolved by switching to a multidivisional form. Adopting a TCT perspective, the multidivisional form presents several advantages: it has access to more accurate information about divisions, it can modify incentives and replace inefficient managers more easily, and it can control the strategies implemented by the divisions. These arguments may be true in the times they were formulated yet in current times they are thought to have lost their significance due to the growing role of external investors.

In reference to the TCT and multinational enterprises, the multinational enterprise focus merely questions the existence of multinational in place of questioning the existence of the firm. The internalization school repeats the reasoning of the TCT in application to multinational enterprises: the more complex and uncertain the nature of a transaction involving heterogeneous products and a small number of participants (buyers and suppliers), the more likely it is that it will be internalized.

Other contributions of the TCT to organizational design include hybrid forms of organization and other alternate forms of organization. Hybrid forms of organization refer to intermediate forms of governance that are neither markets nor hierarchies and include long-term contracts, joint ventures and franchises. Originally, they were thought to be unstable by Williamson. With time he grew to

[9] This is based upon Alfred Chandler's historical study of strategy and structure in large American firms, which detailed a surge in M-form organization within these institutions.

acknowledge that they occur as often as markets and hierarchies. It can be reasoned that hybrid forms of organization exist because of the benefits they present. They give us the best of both worlds: stronger incentives and adaptive capabilities than hierarchies and more administrative control than markets (Barney & Hesterly, 1996, p. 122).

In addition to the previous applications, which focused exclusively on the uses of the TCT in a mere economic and traditional business capacity, the TCT has also been used in other fields. For example, it has been used to arrange the internal organization of Congress and public administration as well as address the role of trust in economic exchanges, the financing of firms, and the functions of corporate governance.

The Transaction Cost Theory has attracted supporters as well as critics. There are three main criticisms directed at the TCT: its focus on cost minimization, its understatement of the cost of organizing and its disregard of the role of social relationships in economic transactions (Barney & Hesterly, 1996, p. 123).

The first of these criticisms is of Williamson´s argument that “economy is the best strategy”. The emphasis on cost minimization is viewed as erroneous and the contradictory resource-based theory suggests, “creating and exploiting transaction specific investments under conditions of uncertainty is essential if firms are to gain long-term success” (Barney & Hesterly, 1996, p. 123). Additionally, this theory argues that minimizing transaction costs is of little benefit if a firm has no transaction specific assets that are highly valued by the market and, therefore, avoiding opportunism and minimizing governance costs are of lesser importance (Barney & Hesterly, 1996, p. 123).

The TCT´s second criticism refers to its tendency to understate the costs of organizing transaction within the boundaries of the firm. The TCT maintains that the presence of a third party (the boss) resolves disputes, including those internal to the firm, more efficiently than market governance. Realistically, this does not always occur due to the possibility of opportunistic behavior on behalf of the authority figure as well as the possibility of lengthy and costly internal bargaining.

Neglect of the role of social and cultural forces in economic activity is the third main criticism of the TCT. American sociologist Mark Granovetter, who has studied economic sociology, points out that networks of social relationships are embedded with transactions. Expectations formed by the history of the relationship influence these transactions. Two friends may trade specialized assets without formal agreements or governance arrangements because they share a relationship characterized by mutual trust. Contrarily, distrusting the person with whom you are contemplating carrying out a transaction surely influences your final decision of carrying out the transaction or not. Despite originally overlooking this factor, current scholars are exploring the significance of social forces in the TCT (Barney & Hesterly, 1996, p. 123).

1.4 Conclusions

The transaction cost theory is an interdisciplinary theory that merges economics with organization theory. Coase´s original query as to the boundary of the firm was furthered by Common´s recommendation to center economic theories upon transaction and governance (or organization). These ideas, along with many others, flourished into what Williamson developed into transaction cost economics.

Approaching governance structure from an economic perspective based on transaction costs should imply the implementation of a governance structure that molds itself to the transaction´s characteristics, ensuring that the exchanges is realized as effectively as possible. The dynamic nature of exchange relationships indicates the need for governance structures that evolve in order to adapt to the transaction´s variations over time. With this in mind, the decision to make or buy seems relatively complicated and is not as black and white as the theory may lead one to believe.

2. Practical Application of the Transaction Cost Theory

2.1 Introduction

A theory is defined as a plausible principle or body of principles offered to explain a phenomenon. Its validity should be examined by adopting a practical approach and by testing its ability to explain said phenomenon in the real world. The transaction cost theory attempts to explain the phenomena of economic organization – the decision to *make or buy*. With this in mind, the objective of the following portion of the dissertation is to analyze the transaction cost theory´s capability to rationalize the decisions of the companies studied in the following cases and challenge the limitations of the TCT.

The methodology used to execute the study varies from case to case. The case study of the glass making company consists of a direct interview with the firm´s proprietor to acquire information about the company, it´s activity and the thought process behind the decision to internalize the activity of beveling the glass. Contrarily, the information for the case study on *onefinestay* hails from the company´s website and travel publications since they do not share corporate details with the public given that they are a recent company with a different business model than their competitors. Following a description of the company and its activity, there is an account of the transaction that was internalized, a justification of said decision according to the attributes and characteristics detailed in the TCT, and a conclusion of whether or not the decision to internalize the activity was sound.

Prior to proceeding with the case studies, a brief summary of the TCT is presented. A firm is presented with certain costs when carrying out a transaction. These costs are made up of direct costs associated with production and transaction costs. The latter has two aspects to consider: strategic and economic. The TCT focuses on the economic aspect of transaction costs. According to the TCT, an activity will be internalized when, under the assumption that the production costs are equal, the transaction costs of organizing the activity within the firm is less expensive than the market alternative.

2.2 Case Study: López Glassworks

2.2.1 Company Background & Description of the Case

López Glassworks (Cristalería López) is a small glassworks company established in 1990 and located in Feáns, La Coruña. The company does various types of works with glass – window and door repairs, mirrors, reinforced doors, and commercial work, among other activities.

Beveling, which involves reducing a straight edge to a sloped edge, is a feature often demanded by clients. This activity requires highly specialized machinery, which would imply a significant investment on behalf of the company. In La Coruña and its surroundings, there were only four local glassworks companies who possessed the beveling machinery in the 1990s – El Reflejo, El Bisel, Unión Cristalera and Cristalería La Luz. Originally, López Glassworks subcontracted this activity to El Reflejo. In other words, López Glassworks applied market governance to coordinate this transaction.

By contracting this service to El Reflejo, López Glassworks depended on them to execute the task in a timely manner so as to ensure the delivery date promised to the client was met. López Glassworks was faced with the problem that El Reflejo had its own orders to fulfill and additional beveling jobs to complete. Oftentimes, López Glassworks´ orders were delayed so that the glassworks company could complete the orders of more important clients. Also, another problem that elevated costs was the lack of warranties. Should any pieces of López Glassworks break while at El Reflejo, El Reflejo would not substitute the piece or cover the cost of replacing the piece; López Glassworks was responsible for bringing a replacement.

Given the delays and dissatisfaction with the glasswork´s company, López Glassworks decided to internalize the beveling activity in 2005. Additional cost analysis indicated that investing in the machinery necessary to carry out the transaction proved to be a sound decision since the cost of coordinating this activity with the other company was elevated (high transaction costs) – checking machinery availability, transporting[10] and dropping off the pieces of glass that need to be beveled, picking up those pieces upon completion, calling to check on the order status and to coordinate logistics, verifying that due dates are met, etc. Information asymmetry did not present a major problem since the two companies carry out very similar tasks, work within the same sector and are located in the same geographic area. Does the TCT support López Glassworks´ decision to invest in the beveling machine and internalize this activity?

2.2.2 Analysis

The TCT indicates that an activity will be internalized when, under the assumption that the production costs are equal, the transaction costs of organizing the activity within the firm is less expensive than the market alternative. The assumption that production costs are equal is slightly demanding in realistic situations. Typically, production costs are lower in the market than within the firm, yet even in this situation, there is a possibility that the transaction costs of coordinating the activity in the market are significantly higher than coordinating the same activity within the firm. In those cases, the total cost of coordinating the activity within the firm is lower than realizing the exchange in the market, which would indicate that the activity should be internalized to economize in total cost.

Typically, an activity is integrated within the boundaries of the firm when it presents a high level of asset specificity, uncertainty and frequency. In spite of this, sometimes although the transaction costs of realizing the transaction within

[10] Logistics costs, such as transporting the pieces, dropping them off and picking them up are not considered transaction costs, but could be classified as production costs, which would affect the total cost of the exchange.

the firm are lower than coordinating it through the market, the company may decide not to follow the TCT´s logic because of financial reasons or because it may not be profitable in the long term. With this in mind, the previously mentioned transactional attributes will be analyzed in reference to the beveling activity.

Asset Specificity

Asset specificity applies to investments that have a single function and its usage is limited due to some kind of restriction. The greater an asset´s specificity, the lower its potential alternative uses or resale value. In this case, two types of asset specificity can be identified: physical asset specificity and site specificity.

Beveling glass requires a beveling machine, which has no alternate uses. Thus, the activity presents a high level of physical asset specificity. Site specificity arises from the need for a workshop area to store the machinery and carry out the activity.

The background information about the López Glassworks indicates that during the 1990s only four local companies possessed a beveling machine, which could be identified as a scenario of small numbers (reduced agents). Theoretically, in situations of small numbers opportunism may not be avoided, as is the case of situations with large number exchangers. Opportunistic behavior may be better controlled by adopting a hierarchy governance structure since internal organizations have the ability to monitor behavior easily, unify interests and can mediate differences more easily than the market.

Opportunism tends to occur when there is information impactedness (when one party has a greater understanding or information about a transaction than the other party). The problem of information impactedness tends to be a greater problem in small number transactions due to the lack of information transparency. The diagram illustrated in *Figure 4* represents the relationship between opportunism (human factor or behavioral assumption) and small numbers (environmental factors) that influences the governance structure chosen.

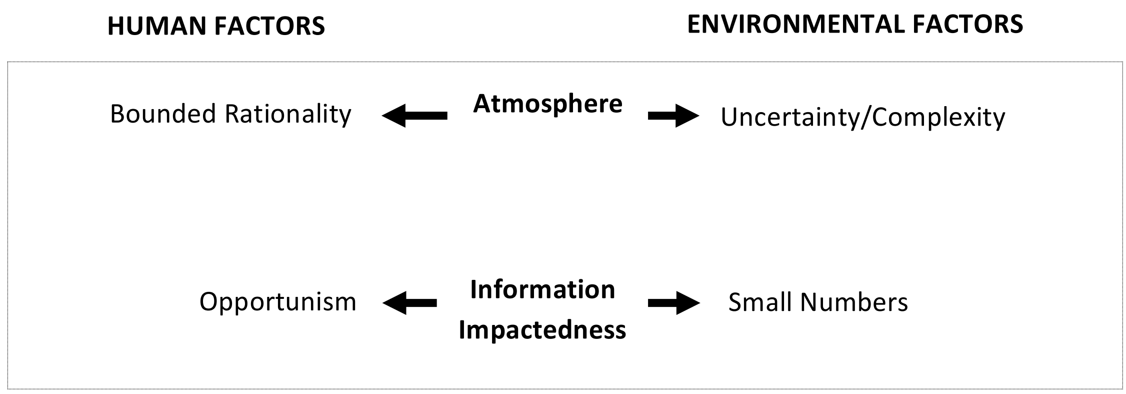

Figure 4: Combination of human and environmental factors that cause the existence of extraordinary transaction costs in the market[11]

Uncertainty

The concept of uncertainty arises due to the existence opportunistic behavior and bounded rationality in cases of highly specific assets. The greater the uncertainty, the more background information will be sought prior to establishing the transaction and the greater the contract´s complexity in order to anticipate future eventualities. Both of these actions would elevate the transaction costs associated with the exchange. Also, an elevated level of asset specificity implies a greater level of uncertainty within a transaction.

López Glassworks is faced with considerable uncertainty of whether or not the other glassworks company will meet the deadlines or whether they will place López Glassworks´ pieces to the side to fulfill the orders of more important clients, which matches the concept of uncertainty presented in organizational theory. The phone calls López Glassworks had to make to check up on order statuses as well as to coordinate deliveries of new orders and pick-ups, however, are considered transaction costs. These phone calls were becoming rather costly and the coordination was becoming complicated; internalizing the activity would save López Glassworks the time and cost of obtaining that information. This could be related with the atmosphere relationship depicted in *Figure 4*. Atmosphere refers to the notion that interaction effects, such as the unreliability of El Reflejo to complete the jobs on time and the irritation of having to constantly call in to check up on orders, could

[11] Adapted from: Williamson, O.E. (1983), *Markets and Hierarchies, Analysis and Antitrust Implications: A study in the economics of internal organization*. New York: The Free Press.

influence the transaction and ultimately change the organization of that activity. The complexity of coordinating the activity ultimately factored into López Glassworks´ decision to integrate the beveling activity.

Frequency

The greater the frequency of a transaction, the more it tends to be internalized. Glass beveling is considered a recurrent transaction given the demand for this feature, especially taking into account the construction boom during those years. Recurrent idiosyncratic transactions tend to be internalized within the firm, which corresponds with Lopez Glassworks´ situation of having a strong and steady weekly demand.

Final Remarks

According to the transactions characteristics – high specificity, high uncertainty and recurrence – the decision to integrate the activity within the firm is backed by the TCT. López Glassworks seems to be basing its decision on an economic component, which is covered in the TCT. The coordination costs stemming from market governance are considerably higher than its alternative, proving that in a situation of recurrent idiosyncratic transactions market governance is ineffective. Unified governance allows transaction cost economizing with the added benefit of being a very adaptable structure since changes can be made and applied almost instantaneously.

2.3 Case Study: onefinestay

2.3.1 Company Background & Description of the Case

Onefinestay is a start up company based in the United Kingdom who has capitalized on the trend of travelers seeking alternative options to hotels and whose main activity is renting luxury vacation homes. Founded in 2009, the company currently offers the possibility of renting luxury vacation homes in London and New York City and is hoping to expand its services to other major cities around the world. *Onefinestay* flourished from the notion of the *unhotel*; this concept allows renters to live like a local in their chosen home, but with the added benefit of having hotel-like amenities. These services include maid service, fresh linens, upscale toiletry products and concierge service. *Bloomberg BusinessWeek* has coined it "the rich man´s Airbnb[12]" (Suddath, C., 2012) and it is a spot on observation.

The company works in two phases. First, the owners of homes are subjected to a membership process and, once they are approved, the home is offered to prospective travellers though the website.

The membership process consists of the following stages:

- The owner proposes listing the home and fills out a questionnaire about the home (address, neighborhood, number of rooms, features, availability of the home, etc.).
- The home is scheduled for a photo session to envision how photogenic it is and whether or not it would appeal to clients.
- An interview is scheduled with the owner of the property, to make sure that the interests between *onefinestay* and the owner are aligned.

Once the property has been approved and listed, the bookings are the exclusive responsibility of *onefinestay* and are made through the company´s website. The owner merely needs to indicate on the calendar application the days the home will be available. There is complete anonymity between the owner and renter. The properties are listed on the website and the client can refine the search according to availability, location or the number of rooms desired. Each booking includes the following services: Wi-Fi, a personal welcome, 24-hour client support, an iPhone to use during the stay, hotel-grade cleaning, toiletries, towels and upscale linens.

The home services team manages cleaning, maid service and linen supplies. When a home is booked, a member of the home services team or an

[12] Airbnb is a San Francisco-based company founded in 2008 that offers a portal to vacation rentals, but these locations are not exclusively luxury homes as in onefinestay. They are present in 192 countries. Airbnb merely acts as a site for homeowners to post available lodging options and for renters to find a unique space within their price point. Cleaning services and other amenities are subject to the owner´s responsibility; he is not required to provide additional services.

operational employee will go through the apartment with the owner prior to the guests arrival and make note of any rooms that must be sealed off or valuable pieces that the owner would like stored during the guest´s stay. The home services team will then clean the home, switch the owner´s linens and toiletries for those provided by *onefinestay,* and finalize any other preparatory details. The maid service also cleans the apartment once the guest has vacated the home and prepares it for the owner´s return.

The in-house home service differs drastically from Airbnb´s policy in which the owner is solely responsible for the apartment´s upkeep and cleaning. The decision of onefinestay to internalize the housekeeping services is the topic of analysis in the following subsection. Does the TCT support *onefinestay*´s decision to internalize the housekeeping services?

2.3.2 Analysis

Asset Specificity

The activities encompassed within the home services division appear to lack any type of asset specificity. Cleaning a home, changing the linens and ensuring the availability of high-end toiletries are activities that could be carried out easily by the market. The only possibility of asset specificity lies in the physical asset specificity as the cleaners might need professional cleaning appliances (such as vacuums or steamers) to carry out their tasks at a hotel-grade level, but presently these can easily be acquired by anyone at a specialty store, which would nullify any potential specificity claims.

Uncertainty

In this case, it was determined that there is no asset specificity, which would permit the conclusion that there is no uncertainty. Additionally, it should be noted that if the housekeeping services were contracted to a professional cleaner or cleaning company, it is very easy to verify that they have completed their end of the deal. With a cursory review of the home, *onefinestay* can tell whether or not the home was properly cleaned or not. This would support the conclusion of a lack of uncertainty in this transaction.

Frequency

The greater the frequency of a transaction, the more it tends to be internalized. This is the only attribute that backs *onefinestay*´s decision to internalize the home services activities. Cleaning and the home preparation activities are very frequent due to *onefinestay*´s business: luxury vacation rentals. Homes are rented constantly and there is a continual need to clean the homes and prepare them for either the renter´s arrival or their owner´s return.

Final Remarks

According to the previously studied attributes, the home services activities would not be internalized according to the TCT since the activity is not highly specific and there is a lack of uncertainty. Focusing on the economic aspect of transaction costs, the TCT would theoretically support a market or hybrid alternative of organization. However, this would highlight a limitation of the TCT: a disregard of the strategic motivator for internalizing certain activities.

Occasionally, strategy and economic motives are aligned towards the decision to assume activities within the firm, but in this case it can be deduced from the transactional attributes that the reason for internalizing the home services is strategic. The firm targets a niche market of upscale vacation rentals, thus pursuing a differentiation strategy. It would need to guarantee the utmost standard of quality not only in the homes selected, but also their maintenance and upkeep. An in-house cleaning team would ensure that the high standards are maintained since the company employees would fulfill the tasks more thoroughly than an external cleaner given that, as an employee, they share the same interests as the firm.

The delegation of tasks, such as cleaning and home preparation, to a specialized company would introduce the problem of residual loss. The divergence of interest between *onefinestay* and the cleaning company would suggest the need of monitoring the latter, which increases transaction costs for *onefinestay.* Accordingly, the economic aspect of the TCT pertaining to transaction costs may be considered as a factor in *onefinestay*´s decision to internalize home services. Since *onefinestay* failed to share whether or not the cost of hiring a cleaner or cleaning company influenced the decision to assume the home services activities, there is no certain information supporting this argument. Therefore, it may be concluded that strategy is the driving force behind *onefinestay*´s decision to internalize home services.

Despite possessing a sound reasoning and the capability of explaining many other organizational phenomena, the TCT is faced with a limitation in this situation. Oftentimes, although certain activities may be less expensive to organize through the market, the cost of correcting errors may be greater than those resulting from internalizing the activity. If *onefinestay* decided to externalize the home services activities and the cleaning company carried out it´s task poorly, inadequate monitoring of the process by *onefinestay* to correct this error could result in a very unhappy homeowner or client. Furthermore, the client may abandon them and *onefinestay*´s luxury reputation could be jeopardized. It this sense it is less costly for the company to internalize the activity than repair a damaged reputation or recuperate unsatisfied clients.

2.4 Conclusions

The previous case studies allow for a unique view of the TCT and its application in realistic situations many firms face. These cases allow a more complete understanding of Williamson´s transaction attributes and organizational attributes and their influence on the coordination of exchanges. In spite of this, these cases also highlighted that although the TCT has the ability to explain the decision to internalize and predicts which governance structure best adapts to the transaction´s characteristics; the theory´s prompts do not necessarily coincide with the firm´s decision in real life.

The TCT does not recognize that financial and strategic factors influence the firm´s ultimate governance structure. In the first case, transactional attributes would suggest the López Glassworks should integrate the activity within the firm yet due to financial restrictions that are common to young companies, the activity was outsourced in the first moment although finally it was integrated. Similarly, the *onefinestay* case study brought to light a considerable limitation of the TCT – disregarding strategic factors that influence a firm´s decision.

These case studies focus on vertical integration, which is assimilated as a hierarchy governance structure, and its main alternative market governance. Both of these are extreme forms of organizations; the companies did not consider alternative hybrid forms.

For example, López Glassworks only considered two options – internalize the activity or outsource the activity to another company. A hybrid form consisting of a strategic alliance with another or multiple local glassworks company/companies could have been another option. Granted, one would need to calculate the transaction costs that could arise from the coordination of such a governance structure, but this is another option. A hybrid form that may have been a valid option for *onefinestay* is long-term contracting. This alternative is closer to the market governance end of the governance structure spectrum, but given the strategic necessity of ensuring quality standards comparable to a luxury hotel the direct internalization of the home services activities was a sensible decision. The environment´s dynamic nature may prove that, in the future, shifts in the transaction´s attributes may lead them towards changing these governance structures in order to economize on transaction costs.

Final conclusions

It is undeniable that the transaction cost theory is extremely valuable in the quest to comprehend the organization of economic activities. As Williamson suggests, the transaction cost approach most likely has a greater relevance for studying commercial enterprises since natural selection forces operate with greater force in those types of enterprises, but this does not diminish the importance of transaction cost economizing to all forms of organization (1981a, p. 573). Generally, governance structures that are more efficient at transaction cost economizing will substitute inadequate forms of organization except in cases where the trade-offs prove that such an adaptation is not worth it (Williamson, 1981a, p. 574).

“While it is injudicious to claim too much for the transaction cost approach, neither do I want to claim too little” (Williamson, 1981a, p. 574). Like all theories, the transaction cost theory has its limitations and is not capable of explaining all organizational phenomena, but it is able to explain a great deal of matters. Its main application of studying vertical integration is rather enlightening given the effect that an expansion of a company´s range of activities could cause on said enterprise´s future. It is critical that companies properly assess the characteristics of a transaction prior to internalizing the activity since integrating activities that are of no use to improving the company´s competitiveness could be detrimental to its future.

The purpose of this dissertation was to better understand the logic behind a company´s decision to internalize an activity, thus broadening its limits. A review of the Transaction Cost Theory and its antecedents were necessary to accomplish this objective. Although this theory may have had limited origins, Williamson´s ability to operationalize the theoretical foundations facilitated a further development of these notions and proves that the future may hold advancements to the theory that may reduce its boundaries, broadening its scope of application.

Finally, transaction cost economics' merging of various fields of study – law, economics and organization – reminds social scientists that all fields are connected. To properly comprehend problems in one of these fields, the ramifications of the other fields on that problem must be considered in order to properly diagnose the underlying causes of the problem and present an effective solution. This make transaction costs framework a very useful and versatile theory, however, more research is needed to strengthen it. In the words of Williamson:

> "The economics of organizations has been and is an exciting research arena. Participating in this has been satisfying to me and others and I think that the new generation of scholars can recognize that their predecessors have made headway. But there are also limitations and big challenges ahead. So let´s push the boundaries. (N.A., 2007, pp. 384-85)."

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