*Strategic Management*, 9e: Chapter 11 study guide

Transaction cost economics-based strategy

**Definition**: Transaction Cost Economics focuses on minimising the costs of production and the costs of transactions related to the operation and management of organisations.

Transaction cost economics (TCE) is therefore focused primarily on the resources of running an organisation: the costs of raw materials, labour, overheads and so on. Nevertheless, it is in every part of the value chain – inputs to the chain, manufacturing within the chain, the costs of using in-house marketing and selling as against using outsiders to undertake these activities. The basic principle here is that all such costs associated with adding value in the organisation are kept to a minimum. That is probably the easiest part of TCE to understand.

In addition, TCE is also focused on what are called the transaction costs of *using the market* *outside* *the organisation* to ensure that costs are kept to a minimum: comparing what it costs to undertake the cost within the company against what it would cost for another organisation to undertake the same task. Such costs will include the cost of searching the market to find the lowest raw material costs, the lowest labour costs, the lowest marketing costs, etc. This part of TCE relies therefore on searching, knowledge of alternatives, negotiating with other people in the marketplace. This part is perhaps not so difficult to understand in principle but much more difficult to resolve in practice.

For example, how do you really know that you have the lowest costs? Do you have to search around in the market place each time you make a purchase? Or do you assume that searching for the second, third and fourth time will not yield any better result than the first time? And, in any event, you have already entered a contract for the year to obtain a better price from your supplier: do you really want the cost of breaking that contract? As soon as you start asking perfectly reasonable questions like this, life becomes more complex.

To explore these issues in more depth, Professor Oliver Williamson began to set out some of the basic principles and determinants of TCE. These principally surround the bargaining and search processes that occur as the marketplace is searched and contracts agreed for suppliers to undertake the tasks concerned with generating value in the organisation. Classic economics can help here with its assumption that markets work best when there are many buyers and sellers who readily interact to provide much information on costs and prices. Williamson argued that this meant that TCE relies on the availability of information: if there are few buyers and sellers or they refuse to share information equally amongst themselves, then such bargaining becomes more difficult and the associated costs are likely to rise.

More fundamentally, readers will recognise that the whole area of TCE is related to a topic discussed in Chapter 4, Section 4.2 on the ‘make-or-buy’ decision: do we make the product ourselves or do we buy in the product from another company? It is not possible in this short note to explore every aspect of TCE but readers may like to read Chapter 7 on TCE by Andy Lockett and Steve Thompson in: *Advanced Strategic Management*, Second Edition, edited by Mark Jenkins, Véronique Ambrosini with Nardine Collier, published by Palgrave.

Professor Lynch acknowledges the above source in writing this note.