

Integrating Transaction Cost Analysis and Agency Theory

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November 5, 2007

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Abstract

The meaning of integration has evolved: in 1828, “to integrate” simply meant to make entire. In 1913, “to integrate” meant to form into one whole or complete. Today, it means to form, coordinate, or blend into a functioning or unified whole; that is, to unite with something else. Proposed is a holistic merging of two theories: transactional cost analysis and agency theory—merging the agent and the transaction as key “units of analyses.”

All aspects of business are related to the concept of exchange (Williamson 1981); maybe even all aspects of life. Goods are exchanged in the market-place; employees exchange their time and talents for financial rewards (Bergan, Dutta, and Walker, Jr. 1992). In isolation, one-time exchanges generally occur at “arms-length” with little trust between the two parties. In most practical market settings, such exchanges may create market failure, especially if the costs to exchange become too high. From this operational framework, reducing the costs required to exchange is essential to building long-term exchanges.

As the trust between the two parties increases, the costs for the exchange decrease, the frequency of exchange increases, and everyone benefits (Williamson 1981). With the given models of choice theory, each party has self interests inherent to the exchanges, and conflict of interest may result (Hart 1995). Adam Smith would argue these interests are morally founded (e.g., self-interest without guile); however, modern economic thought suggests that at times, a party will exploit an exchange in an opportunistic way, self-interest with guile—sins of omission or commission. Since opportunism is difficult to forecast before an exchange and a model needs to account for a party’s potential opportunism, it becomes important to identify if opportunism is habitual or a one-time event. Managing opportunism is the key for reducing transaction costs and improving relationships, all positively influencing exchange.

Before discussing the exchange interface, several antecedents need to be discussed. First, the assumptions of risk need to be determined. As isolated theories, transactional cost analysis (TCA) and principal-agent theory (PAT) differ on this assumption; one assuming risk aversion and the other assuming risk neutrality. An integrated assumption needs to include risk, with a desire to minimize it. Risk is a function of the uncertainty associated with the exchange, based

on environmental and human factors. Environmental factors include the general economic conditions, the perceived relative power between parties, and demand issues (monopolistic vs. monopsonistic). Human factors related to risk and uncertainty are based on perceptions of human nature: humans have bounded rationality (Rindfleisch and Heide 1997), are autonomous actors able to choose (Hart 1995), and are capable of purposefully deceiving. These human elements can create problems in an exchange. It becomes very difficult to select a beneficial exchange partner—minimalizing the potential moral hazard associated with making an incorrect exchange partnership is essential.

At the firm level, exchange has two fundamental components: external exchange with suppliers or vendors and internal relationships with employees. The firm, as the principal, is trying to manage the exchange process: especially before and during exchanges. The suppliers or vendors, if selected, become agents for the firm. Once an initial exchange is agreed upon, the relationship develops; both parties begin to manage the uncertainty and attempt to cultivate trust. The durability of this investment as an ongoing exchange determines the asset-specificity of the relationship (Rindfleisch and Heide 1997), potentially locking a firm into one relationship (making it very difficult to switch or redeploy resources). Economizing this durability externally determine the boundary of the firm (make versus buy) and internally determine the selection of employees. Either way, the asset-specificity becomes a function of the human capital and the ability to monitor the activities the agent performs for the firm (Williamson 1981).

Before a commitment is initially agreed upon, both parties search for potential synergies in the marketplace. The firm as the principal searches and screens; the agent suggests a matching capability through signaling and self-selection (Bergan et al. 1992). Due to the nature

of this process, ambiguity creates risk. Bounded by rationality and incomplete hidden information (Bergen et al. 1992), the principal needs to prevent adverse selection—selecting a party that is not qualified or capable of performing the required activities in an expedient manner. In a dynamic environment, the perceived trust and commitment become even more essential as the principal will need the agent to be willing to adapt as circumstances change. Self-enforcing contracts become the solution to the uncertainty associated with selecting an agent (generally in the external context). Each party invests substantially in the relationship, using hostage credibility to signal commitment. Induced dependence needs to be balanced by commitments of interdependence. Again, self-enforcing contracts as a signal still could be deceptive (ugly princess) based on hidden information. Any exchange agreement has some level of risk.

During the exchanges, management of risk, uncertainty and ambiguity is also important. How do you manage the expectations associated with the commitment? Neither party wants the other to “shirk” from the mutual agreement. This contract becomes a social norm of expectations based on labeled relationship behaviors with antecedents and implications for deviations from expectations (Rindfleisch and Heide 1997). Asset-specific investments that create lock-in necessarily create a need for the firm to hedge its risk. Governance as management of expectations can reduce risk by mitigating potential opportunistic behavior. Monitoring, incentives, selection and socialization are strategies to manage expectations, safeguarding against opportunism (Wathne and Heide 2000).

In order to understand each of these management strategies, opportunism must first be clearly understood. Is opportunism a correct descriptor of human behavior (Wathne and Heide

2000)? At times, it is. If resources are deployed to manage opportunism, transaction costs are increased potentially killing exchanges between parties. Reducing potential opportunism *ex ante* clearly becomes important. Opportunistic behavior is strong or weak, active or passive with intent to deceive. This notion of guile can be described as lying, stealing, cheating, misleading, distorting, disguising, obfuscating, confusing, and so on. Specifically, this guile takes form opportunistically as evasion, violation, refusal to adapt to changing circumstances, or holdup (forcing a renegotiation due to dependency and environmental changes)—all violations of the norms established in the mutual agreement (Wathne and Heide 2000). Resultantly, in addition to increasing costs associated with the exchanges (Hart 1995), opportunism potentially can redistribute the relational power between parties and redistribute the economic profits of the agreement.

Because only some agents will be opportunistic at certain times, it is financially impractical to eliminate all opportunistic behavior. Why spend money to implement system-wide governance strategies? Tolerance for opportunistic behavior is more economically feasible, especially if the behavior is a one-time occurrence, not a tendency (Wathne and Heide 2000). By minimalizing the costs associated with governing the behavior during exchanges, economization again prevails.

Firm level strategies have embedded strategies that relate to opportunistic management within the firm. For example, human resource departments develop screening procedures and selection criteria before hiring; after hiring, training programs socialize the expected norms of the firm (Bergen et al. 1992; Wathne and Heide 2000). Aligning interests and reducing information asymmetry during employment through appropriate incentives and review processes

(monitoring) also reduces opportunism. Most importantly, when a signal of potential opportunism is discovered, appropriate feedback and education with severe implications need to be clearly signaled to the offending party: tolerating the one-time event but signaling opportunistic tendencies will not be tolerated.

Integrating TCA with a transaction as the fundamental unit of analysis and PAT with a human as the fundamental unit of analysis becomes a useful framework to discuss exchanges between parties, the essence of marketing. The blurred result is a phenomenological perspective: the transaction or exchange is the object, with equal importance on understanding the intentionality of the actors in the exchange. Reducing risk and its costs will improve the durability and frequency of the exchanges. Opportunism becomes the most important risk to mitigate.

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