

Transaction Costs and Economic Performance: An Institutional Approach

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ABSTRACT

The institutional arrangements, such as the property private order, market, law and other social institutions, governance, cannot function without certain costs. Such costs are not generally or necessarily measurable, but their identification helps understanding how the economic activity is organised and, therefore, appropriately explaining its performances. The study illustrates the fundamental theoretical research on the issue of transaction costs, as reflected in the institutional analysis entitled "Transaction Costs Economics". The inherent connection between the transaction costs and the entrepreneurial activity indicates the need to restate and extend the neoclassical approach. The argument calls up the institutional context of the property rights, which are in fact decisive for the manifestation of entrepreneurship. The restatement of the approach relates to knowing the fact that the property rights and the transaction costs influence the entrepreneurial activity and, therefore, the overall economic performances.

KEYWORDS: *Economic Performance, Institutions, Property Rights Transaction Cost.*

JEL CLASSIFICATION: *B52, D23, O43*

1. PREAMBLE

In the economic approach of institutions of Douglass North, recipient of the 1993 Nobel prize, *the theory of institutions "is constructed from a theory of human behaviour combined with a theory of the costs of transacting"* (North, 1990, p.27). By combining these theories, one can understand why institutions exist and what role they play in the development of the society. North also mentions that if you add the theory of production, one can analyze the institutions implication over the economic performance. The author mentions afterwards that if the *theory of production* is added, then the institutions' implication in the economic performances may be analysed.

Transaction costs would represent, to this effect, the major "plot" of the entire research project and the field to be analysed meant to give operational value to the manner the institutions succeed to give force to economic development. Besides, the following chapters hereof are meant to present a theoretical analysis of and to empirically operationalise the transaction costs. The essential purpose consists in evaluating the practicability of the transaction costs as a specific indicator of assessing the quality of the institutional arrangements. Contrary to the *mainstream* approach in the transaction costs economy, I will

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try to show that the logical line of the approach is in general “from institutions to transaction costs”, which makes the “transaction costs” phenomenon become the efficiency factor for any institutional arrangement that burdens the operation of economic activity.

The main thesis of the “institutional economy” of transaction costs concerns the sense and the interpenetration degree of the *cause* and *effect* matrix in the relation institutions-transaction costs. The transaction costs pertinent for the economic performance have their own institutional “anchors”. That is why, any strategy for institutional reform and change, non-contradictory and sustainable, has to focus on the ultimate cases – institutions, respectively transaction costs - when the transaction costs’ control and reduction show the practicability of changing the institutional arrangement.

2. TRANSACTION COSTS AS INSTITUTIONAL FACTOR

Even if in the specialty literature, from a conceptual and methodological point of view, there are no general approaches of transaction costs, the empirical challenges are very up-to-date, with an actual potential to clarify the field of institutional reform. To this effect, various pragmatic studies on transaction costs may be invoked, as these are relevant from the point of view of the operationalisation and quantitative assessment: Allen (1999), Foss (2006), Kang (2001), Meyer (2001), Păun (2010), Shelanski (1995), Wang (2003, 1999), Williamson (2011, 2010) etc. But, in order to have an adequate integration of transaction costs in the analysis of the institutional factor’s quality, the approach must distinguish – following the line of the previous conceptual clarifications – between diverse institutional systems that are categorically different in the logics of their own operation mechanisms. From such perspective we may distinguish between two large institutional systems, respectively two approaches of the transaction costs:

Transaction costs at economic level would represent a real criterion for optimisation, as long as “the transactional argument” is inherent part of the economic calculation’s logics. At economic plan, the empirical approach is related to the estimation of the importance that the transaction costs have for the performances of the business environment in Romania and other countries in European Union. Methodologically speaking, the pragmatic analysis will be based on the assessment of the transaction costs which are correlated with certain indicators of the governance and of the institutional capacity (such as indicators of corruption, of underground economy, of the business environment’s competitiveness), under a *cross-country* analysis meant to identify the institutional constraints over the entrepreneurship and over the economic activity in general.

Transaction costs at political and administrative plan would reflect, as paraphrase of Coase’s generic terms, the costs for the operation of the political and administrative system. In the democratic political system, the collective decision is the result of the complex interactions among citizens, in their capacity as voters, consumers of public goods, elected representatives and State employees, leaders and members of political parties. By definition, the democratic political process is the equivalent to the existence of different electoral coalitions. In the specialty literature – *Public Choice Theory* – their manifestation is designated using specific concepts, such as *rent-seeking*, *political lobby*, groups of interests, State capture. Olson (1999:101) shows how “the more and more complex regulations resulting from the lobby ... increase the level of bureaucracy and the role of Government”. And in front of such complex regulations resulted from the activity of the

interest groups, an entire – economic and legal – arsenal is developed meant to exploit the nature of regulations or to minimise the costs of their enforcement. It is obvious that the operation of the democratic political institutions entails transaction costs the extent of which is decisive for the success of the institutional reforms and changes.

3. “THE ISSUE OF MEASURING” THE TRANSACTION COSTS

Generally speaking, the economists include in the category of transaction costs all the efforts for information, the costs of negotiating and drafting contracts, the costs of protecting the ownership rights and imposing rules and agreements under various contractual arrangements. For example, North (1990, p. 27) states that the costly nature of information is the key of the transaction costs, which would thus consist in “the cost of measuring the valuable attributes of what is being changed and the costs of protecting the rights and of imposing contractual agreements”.

But the issue of “measuring the valuable attributes of what is being changed” reveals the objectivistic perspective used by North to build his theory. But, as indicated in the book *Instituții și prosperitate* (2003), the subjectivism paradigm, which substantiates the whole modern theory of value, excludes the possibility to externally and objectively assess the costs of human action. In relation to this issue, the essential difficulty occurs of operationalizing the transaction costs at an empirical level, by their measurement. As how could the economist express and measure what not even the persons involved in transactions cannot do objectively? Therefore, several difficulties exist in relation to the operationalisation of the transaction costs at an empirical level. One might say that from an instrumentality point of view the transaction costs represent rather a way to formulate arguments, than an empirical, efficiency indicator, really cognizable.

In such context, I believe that the transaction costs’ economy is currently facing, maybe more than ever, *two major challenges* at the level of its empirical relevance.

First of all, it is the most invoked need to “measure”, to assess the transaction costs under some quantitative empirical analyses, able to indicate thereafter the deterministic impact of the institutional variable of the transaction costs.

Secondly, it is about a more extensive challenge, for summarisation and thematic integration of the empirical researches into diverse fields of activity. The insertion of the transaction costs in the logics of the institutional reforms requires going from a partial sector approach, of microeconomic nature, to an integrated approach, aggregated at the level of the entire institutional system indicating the operation of the business environment.

The same empirical framework for “measurement” includes also the assessments of the transaction costs as an inter-country comparative approach. The criteria taken into account refer mainly to the costs that individuals and legal entities incur in relation to the formal institutional arrangement. For example, according to the studies conducted by Benham and Benham (2001), it is about the costs in time and the money that people in different countries must “pay” in order to have a telephone set installed, the waiting time and the (legal and informal) payments necessary to set-up a company, how the underground economy “fuels” the business operation (de Soto, 1989), as well as aspects aiming at the institutional structuring of business environment.

As an aggregate approach of the transaction costs at the level of the entire economy, it should be detailed the attempt to measure the transaction costs made by Wallis and North (1986) regarding the USA economy. Their study underlined the substantial increase of the transaction costs during the period under analysis (1870 – 1970), the transaction costs being assessed at the end of that period at approximately 55% of the national income, as it was about resources allotted in the “transaction sector”. To this effect, in a kind of forced manner, Wallis and North associate (from the quantity point of view) the transaction costs with all the resources of the companies providing agency and transaction services. Such confusion between the transaction sector and the transaction costs entailed several critical approaches regarding the relevance of “measuring” the transaction costs.

However, the entire empirical approach of the transaction costs is built in extension of a simple idea, which was gradually brought up to the level of a scientific postulate: *economic performance depends on low transaction costs*. Such “theorem”, apparently sufficient *per se*, is though raising the issue of its own empirical consistency. If “low transaction costs” mean complete freedom of the resources’ owners to orient their resources according to the most valuable uses, those uses which are according to their subjective assessments, then the “postulate” may fully affirm its empirical consistency based on assessments focused on the economic freedom’s problems. Such analysis has the chance to check the relation manifested in an economy between the economic freedom and the size of the transaction costs (which are imposed on the market participants through various external institutions and administrative constraints on business). But if the authors understand by “low transaction costs” rather the expenses needed for the transactions on the free market, then the issue of measurement brings additional difficulties.

4. TRANSACTION COSTS AND ECONOMIC PERFORMANCE – INSTITUTIONAL LOGICS

Within the actual framework of the economic activity, *the institutional perspective* is explicitly complemented by the relation *institutions – transaction costs*, already analysed theoretically and methodologically. But, hereinafter, under the empirical analysis of the institutional determinants of the economic performance, I will present the way such relation *institutions – transaction costs* stimulates, in diverse directions and with various levels of intensity, the *entrepreneurial activity*. Besides, both the contemporary specialty literature, and the classical one, mention almost unequivocally the vital importance of entrepreneurship for the economic performance: Baumol (1990, 1993), Eggertsson (1990), Kirzner (1997), Knight (1921), Mises (1949), North (1990), Schumpeter (1934), de Soto (2003) etc.

Therefore, the analysis of the institutional capacity of the business environment must start from underlining the institutional and administrative barriers which alter the genuine entrepreneurial initiative (Bjørnskov & Foss, 2008). The natural, predictable result of correcting such barriers will consist in the emergency of a strong private sector, relying on entrepreneurial initiative and autonomously from the political power.

The equation of the economic performance must though be approached and distinguished differently, gradually, in relation to the explanatory factors taken into account. On one hand, it is the *institutions role*, meaning the way the institutional framework orients the

economic activity and, on the other hand, it is the *transaction costs role*, meaning the extent with which institutions burdens the entrepreneurial activity. Thus, the *incentives issue* and the *economic calculation issue*, used to summarise in the previous chapters the matrix of the economic development, will be reflected in such institutional perspective through the following two stages/levels of analysis:

a) *Institutions determine the direction of the entrepreneurial activity.* According to the actual nature of the institutional system in reality, through the structure of the incentives incorporate in its operation, institutions may orient the entrepreneurial activity towards a *productive direction* or, on the contrary, towards an *unproductive direction*, a destructive one. It is well-known the approach suggested by Baumol (1990), according to which entrepreneurial activity may become unproductive when, guided by the institutions with State discretionary power, it is materialised as activities of *rent-seeking* and of capturing State (policies). In an economic climate dominated by State's discretionary interventions, a reorientation of the entrepreneurial behaviour takes place: the impulse to meet the consumers' preferences on the market will be replaced by the need to meet the expectations of the administrations and political power's structures. For example, Frederic Sautet (2005) identifies three categories of entrepreneurship starting from the nature of formal rules: productive (incentives directing the entrepreneurs towards socially beneficial activities), evasive (formal institutions offer the entrepreneurs some incentives for ignoring and avoiding the formal institutional framework, see underground economy). The third category is destructive entrepreneurship which occurs when formal institutions are manipulated and created in a discretionary manner, fact that institutes incentives so that certain entrepreneurs exploit the formal rules, obtaining incomes through political privileges.

In an economy like Romania's, engraved by fundamental institutional transformations, specific for the transition to market economy, State and companies are connected through mechanisms that exceed the standard provision of insuring public assets. Thus, from an institutional point of view, State has the capacity to grant the companies, in a discretionary manner, several benefits: State financing, licenses, explicit and implicit subsidies, allowance for debts towards State budget, some exemptions from fiscal obligations, various facilities. But the entire set of discretionary advantages is not necessarily the equivalent to the reduction of the burden that public sector imposes on business environment, so to the reduction of the State's size in economy (generally estimated through the share of the central and local public budgets into the gross domestic product). In such situation, the discriminatory policies could get an attractive nature (Marinescu, 2004). In general, granting privileges to certain groups or sectors is finally accompanied by the increase of the level of State (fiscal) exploitation over the other economic groups or sectors. This situation creates strong incentives for the development of the behaviour needed to obtain privileges, meaning incentives for orienting major resources towards State capture (see Hellman & Schankerman, 2000). Thus, entrepreneurs will invest in the preference of the Government administration to the detriment of real investments - economically productive - conceived to meet the consumer public's preferences.

b) *Transaction costs determine the intensity of the entrepreneurial activity.* Institutions and their evolution do not give only the direction of the entrepreneurial activity, either productive or unproductive, but also the intensity of its manifestation. And entrepreneurs will be more or less intensely manifested depending on the amount of the transaction costs resulting from any institutional arrangement. While *transaction costs on*

the market may represent real economic opportunities for the entrepreneurial activity, *imposed transaction costs* are certainly explaining the manifestation of entrepreneurial activity in an inverse relation. The higher the transaction costs that are institutionally and administratively-bureaucratically imposed on business environment, the more entrepreneurial activity will be prejudiced (McMullen, Bagby & Palich, 2008). Besides the reason of the incentives, it is about the objective logics of reducing the capital resources which ensure and define, as a matter of fact, the existence of the entrepreneurial activity.

The institutional perspective over the entrepreneurship – transaction costs relation is explicitly complemented by arguments which underline, both methodologically and empirically, the *category of economic freedom*. The entrepreneurial activity may be analysed only through an intrinsic, natural connexion with the institutional framework of economic freedom. Recent pragmatic studies expressively illustrate the importance of the economic freedom institutions for the manifestation of the productive entrepreneurship - Bjørnskov and Foss (2008); Stenholm, Acs & Wuebker (2011); Aggestam (2012); McMullen, Bagby and Palich (2008); Audretsch & Link (2012); Brunetti (2007); Sobel (2008); Wink, Sheng & Eid (2011); Matis, Nagy, Petru & Benyovszki (2010). Essentially, the empirical approaches prove that the increase of economic freedom, by ameliorating the quality of the institutions and by reducing transaction costs that are imposed, stimulate the entrepreneurial activity and economic performance.

It is generally noticed that a high and arbitrary level of taxation and regulation, along with legislative instability, are the main institutional deficiencies contravening the productive entrepreneurship. To this effect, when such institutional deficiencies prevail, the entrepreneurs' preoccupations to avoid transaction costs that are imposed (An experiment in Lima, Peru, conducted by a team of researchers with Instituto Libertad y Democracia revealed the adverse effect of bureaucracy and regulations on entrepreneurship. Thus, the setting-up of a small textile factory, in compliance with all legal provisions, lasted 289 days. Five people hired with full time finally succeeded to duly set-up such an enterprise. The interaction with the bureaucratic apparatus entailed additional costs consisting in requests for payment of tips or bribery in order to expedite the bureaucratic procedures (Hernando de Soto, 1999)), also by unofficial payments to Government bureaucracies, seem to be "productive" efforts. Their purpose is that entrepreneurs be able to find their way through the bureaucratic medley, which ultimately represents the release of certain resources that are under Government control. Thus, the refuge in the underground economy occurs as a plausible solution and, economically speaking, completely understandable. One should not understand that underground economy reflects the manifestation of a certain entrepreneurial deficit (Marinescu et al., 2007, p. 294). In reality, the "refuge" in the underground economy is dictated by the existence of certain fiscal costs and institutional constraints that significantly alter the profitability of such business.

In relation with the mainly macroeconomic paradigm of the Washington Consensus, the transition economy neglected for quite a long time the essential meaning of the institutional perspective, as well as the preliminary need for institutional reforms. Finally, at least as regards some countries in the Central and Eastern Europe, the weak performances of the micro and macroeconomic management are the consequences of the institutional deficiencies, which is the expression of the institutional frailty. Recognising this offers the possibility to construe the failure of the economic reforms based on a vicious circle of the institutional deficits.

CONCLUSIONS

The institutional arrangements, such as the property private order, market, law and other social institutions, governance, cannot function without certain costs. Such costs are not generally or necessarily measurable, but their identification helps understanding how the economic activity is organised and, therefore, appropriately explaining its performances.

In the conventional approach (mainstream) of the transaction costs, the institutional ingredient of low transaction costs seemed to represent the key for the economic development. But any strategy about "aiming at" the reduction of the transaction costs automatically entails the problem of their valuation or measurement, at least for distinguishing among the viability of certain institutional solutions. But beside any constructivist strategy, the mainstream perspective must be reconsidered and complemented, in which the transaction costs are seen rather as obstacles against economic success than natural corollaries of human action and social interaction.

That is why the integration of the transaction costs in the theory regarding the economic development would become more useful and also more coherent, through the conceptual delimitation between the market transaction costs, the existence of which in the human action field is natural, unavoidable to a certain extent, and the imposed transaction costs, the source of which is external to the social order of the market, being the result of the hierarchic structure of the political power, specific for the State institutional system.

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