3. Transaction Cost Economics

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Transaction cost economics is an effort to better understand complex economic organization by selectively joining law, economics, and organization theory. As against neoclassical economics, which is predominantly concerned with price and output, relies extensively on marginal analysis, and describes the firm as a production function (which is a technological construction), transaction cost economics (TCE) is concerned with the allocation of economic activity across alternative modes of organization (markets, firms, bureaus, etc.), employs discrete structural analysis, and describes the firm as a governance structure (which is an organizational construction). Real differences notwithstanding, orthodoxy and TCE are in many ways complements—one being more well-suited to aggregation in the context of simple market exchange, the other being more well-suited to the microanalytics of complex contracting and nonmarket organization.

I begin by contrasting the lens of contract (out of which TCE works) with the lens of choice (orthodoxy). Vertical integration, which is the paradigm problem for TCE, is then examined. The operationalization of TCE is discussed in Section 3. Variations on a theme are sketched in Section 4. Public policy is discussed in Section 5. Concluding remarks follow.

1. The Lenses of Choice and Contract[1]

Big Ideas

Hal Varian has recently distinguished between important ideas and Big Ideas and describes Ronald Coase's classic paper, "The Nature of the Firm" (1937) as a Big Idea (2002, p. C2). Although there is widespread agreement on this, the nature of the big idea took a long time to register. Thus as of 1972, thirty-five years after the publication of "The Nature of the Firm," Coase described his 1937 article as "much cited and little used" (1972, p. 63). It was much cited because it was onto something important, perhaps even big. But it was little used because the big idea was only dimly perceived and/or lacked operationalization (Coase, 1992, pp. 716–718).

[1] This subsection is based on Williamson (2002b).

C. Ménard and M. M. Shirley (eds.), Handbook of New Institutional Economics, 41–65.

The essence of the Coasian contribution has been variously described (Williamson, 1994, p. 202; North, 2000, p. 37; Werin, 2000, p. 45). For the purposes of TCE, I contend that the overarching big idea was to move from choice to contract: bring the lens of contract systematically to bear on economic phenomena of all kinds. For many transactions, of which the make-or-buy decision is one (Coase, 1937), the contractual structure is easily recognized. Other transactions, such as the externality problem (Coase, 1960), needed to be reformulated to bring out their latent contractual features. The object, in these and other cases described herein, is to uncover previously neglected but, often, consequential features, the discovery of which often leads to different and, sometimes, deeper understandings than the orthodox lens of choice affords. If, as James Buchanan declares, "mutuality of advantage from voluntary exchange is . . . the most fundamental of all understandings in economics" (2001, p. 29), then at least some of us should be thinking of economics as the "science of exchanges" (Buchanan, 2001, p. 28).[2]

The Sciences of Choice and Contract

Economics throughout the 20th century has been developed predominantly as a science of choice. As Lionel Robbins famously put it in his book, The Nature and Significance of Economic Science, "Economics is the science which studies human behavior as a relationship between ends and scarce means which have alternative uses" (1932, p. 16). Choice has been developed in two parallel constructions: the theory of consumer behavior, in which consumers maximize utility, and the theory of the firm as a production function, in which firms maximize profit. Economists who work out of such setups emphasize how quantities are influenced by changes in relative prices and available resources, a project which became the "dominant paradigm" for economics throughout the twentieth century (Reder, 1999, p. 48).

But the science of choice is not the only lens for studying complex economic phenomena, nor is it always the most instructive lens. The other main but less fully developed approach is the science of contract. Indeed, Buchanan (1975, p. 225) avers that economics as a discipline went "wrong" in its preoccupation with the science of choice and the optimization apparatus associated therewith. What was needed was the parallel development of a science of contract. Awaiting this, some phenomena would go unnoticed, others would be poorly understood, and public policy error would result.

[2] Students of the history of thought will remind us that catallactics—meaning "the science of exchanges"—has much earlier origins. Indeed, a book by E. B. de Condillac on this subject was published in 1776, which is when The Wealth of Nations first appeared (see Murray Rothbard (1987, pp. 377–378) for an historical sketch). Recurrent interest in the science of contract notwithstanding, it has operated in the shadows of the science of choice. Why the disparity? Here as elsewhere, good ideas need to be operationalized. Contractual analysis has gotten under way in a sustained way only during the past 40 years.