

*An introduction to the governance of inter-organizational relations
within the context of transaction costs theory.*

مدخل لحوكمة العلاقات بين المنظمات ضمن سياق نظرية تكاليف المعاملات

Dr. Bouthiba Abderrahmen ,Mohamed Ben Ahmed University Oran2

abderrahmen.bouthiba@gmail.com

Received: 24/10/2020

Published:03./12/2020

Abstract: The theory of transaction costs referred to integration as a strategic option to ensure the expansion and sustainability of enterprises' coordination mechanism, but it did not expand in clarifying the role of this coordination mechanism in governance of relations between enterprises, Ronald Coase clarified the role of the enterprise as a coordinator between economic activities through the hierarchy of manager's authority, through its ability to coordinate between economic transactions with the lower cost than market coordination. Our study aims to highlight the role of the institutional coordination mechanism in the governance relations between the three integrated enterprises: the enterprise, the supplying enterprise, and the distributed enterprise, the study concluded that there is an important role to replace the market coordination mechanism with an institutional coordination mechanism in the governance of relations between integrated enterprises.

Keywords: Transaction Costs Theory; Governance; Integration.

JEL Classification Codes : M21, M2.

ملخص: أشارت نظرية تكاليف المعاملات إلى التكامل كخيار استراتيجي لضمان توسيع واستمادة الآلية التنسيقية للمؤسسة لكنها لم تتوسع في تبيان دور هاته الآلية التنسيقية في حوكمة العلاقات بين المؤسسات ، إذ أن **ronald coase** قام بتوضيح دور المؤسسة كمنسق بين النشاطات الاقتصادية عن طريق هرمية سلطة المسير ، نظرا لقدرتها على التنسيق بين المعاملات الاقتصادية بأقل تكلفة مما تنسق به الأسواق ، ومن ناحيته فإن **oliver williamson** قام بالتعمق أكثر في العمق الداخلي للمؤسسة ليبين أن الآلية التنسيقية المؤسسية هي أكثر حوكمة من الآلية التنسيقية السوقية. تهدف دراستنا لتسليط الضوء على دور الآلية التنسيقية المؤسسية في حوكمة العلاقات بين المؤسسات الثلاث المتكاملة- المؤسسة، المؤسسة الموردة، والمؤسسة الموزعة-، ولقد توصلت الدراسة إلى وجود دور مهم لاستبدال الآلية التنسيقية السوقية بالآلية تنسيقية مؤسسية في حوكمة العلاقات بين المؤسسات المتكاملة.

كلمات مفتاحية: نظرية تكاليف المعاملات، مؤسسة منسقة، الحوكمة، التكامل..

Corresponding author abderrahmen.bouthiba@gmail.com.

1. INTRODUCTION

The theory of transaction costs, which is considered the most prominent theories of the liberal current, deepened into understanding the nature of the enterprise and its coordination function between economic activities through management centralization and control of coordination costs. In 1937 **Ronald Coase** explained that the enterprise has its own coordination mechanisms that differentiate it from market coordination mechanism. As for "**Oliver Williamson**" has started since the 1970s to further expand the analysis of this coordination mechanism, where he reached to show that this coordination mechanism is more governed in the coordination of transactions, and highlighting the arbitration determinants between these two mechanisms.

The pioneers of this theory pointed out the role of integration in ensuring the activation and sustainability of this coordination mechanism, but most of their business ranged in analyzing the internal depth of enterprise, which made continuous researches to employ this approach in analyzing the relations between integrated enterprises and this is what leads us to pose the following question:

How are relationships between enterprises governed from the standpoint of transaction costs theory?

Accordingly, our study aims to expand the approach of the theory of transaction costs to study the role of the enterprise as a coordination mechanism in the governance of its relationship with the supplying and distributing enterprise.

2. - Introduction to transaction costs theory.

The theory of transaction costs came to clarify and justify the existence reason of the enterprise as **Ronald Coase - winner of the Nobel Prize in 1991** - the godfather of this theory with his contributions to justify the enterprise existence through its ability to coordinate between transactions with the lower costs than markets and **Oliver Williamson - winner of the Nobel Prize for Economics 2009** - developed through his research on the three points, determinants of arbitration between the two coordination mechanisms - institutional hierarchy and free market - pillars of

transactions, as well as the governance system (*Ghertman Michel, Oliver Williamson, 2010, p70*).

If the classical and neoclassical theory considers the institution as a black box and an individual economic agent that works with a mechanical mechanism to maximize his profits (*Adolf Berle Gardiner, 1932, p91*), and that the market is the only coordinator of economic activities, Coase has answered the famous question:

Why the enterprise?

The classical and neoclassical economic theory asserted that the market is the only coordinator of economic activities through the forces of supply and demand and the prices system that called "the invisible hand", **Ronald Coase** explained by saying:

“The normal economic system operates by itself; its current operations are not subject to any control. It does not need any central control. All human activities and needs, supply, demand and production are controlled to consumption through an automatic, flexible and final process” (*Coase Ronald, 1937,p387*).

The classical theory focused on the free natural system in order to help individuals to freely achieve their interests. According to this coordination conception, the economic theory believes that the market is the only coordinator for various economic activities, and neglects the role of the enterprise, and this is what led **Coase** to criticize this only conception of coordination and the coordination role of the enterprise. His thoughts in his article "**The Nature of the Organization**" (*Coase Ronald, 1937,p387*), included the following seven points:

- 1- The nature of the enterprise.
- 2- The existence reason of the enterprise.
- 3- The enterprise's effectiveness.
- 4- Enterprise components.
- 5- The enterprise's limits.
- 6- The dynamics of enterprise.
- 7- Diversity of enterprises.

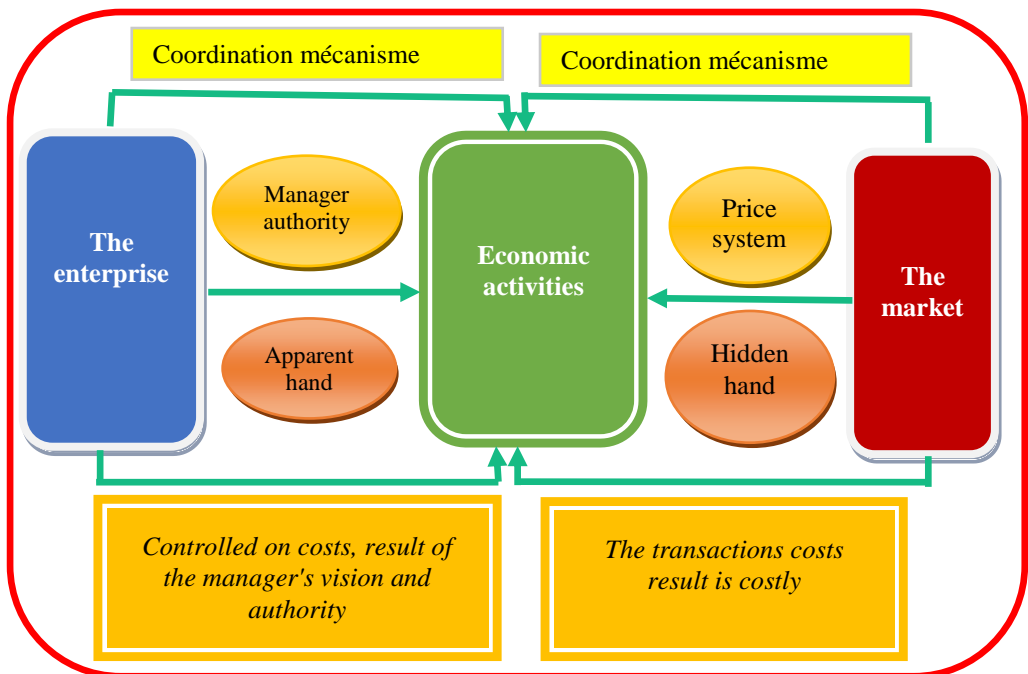
Through these seven points, he tried to justify that the enterprise has a different coordination mechanism from the market coordination mechanism, as it is central and dependent on the authority of the manager: (Bouthiba Abderrahmen, 2017, p50).

3. The approach of "Ronald Coase".

The theory of transaction costs has shown that the difference between the enterprise and the markets is the ability of enterprise to coordinate economic activities in a central way that differs from the market coordination mechanism.

If the markets depend in their coordination on the logic of movement freedom, supply and demand forces, and the price system, then according to the theoretical approach of transaction costs, the enterprise depends in its coordination on another logic, which is the authority of the manager, this authority enables coordination between economic activities in a central way, that makes the hidden hand in markets an apparent hand in enterprises.

Figure 01: the enterprise and markets, a different mechanism coordination.



Source : Bouthiba Abderrahmen, 2017, p50.

The enterprise's application of the principles and methods of corporate governance by following a set of laws, rules, standards and policies that govern the work of companies and disclosure of information related to the enterprise and their transactions with others, society and the surrounding environment will have a positive impact in determining the relationship between the owners associated with the enterprise:

the enterprise's management, Stockholders, bondholders, workers, suppliers, creditors, and consumers.

There are implications for the application of corporate governance supported by the application of cost management tools. The integration effects between them include the following (Mohammed Chahata Khettab, 2010,p14-15):

1. Ensure that administration does not misuse shareholder funds.
2. Shareholders make sure that the administration seeks to maximize the profitability and the value of the company's shares in the long term.
3. Ensure that the administration cares about the basic interests of society in the areas of health and the environment.
4. Enabling shareholders and stakeholders to effectively monitor management.

The question posed by Coase is:

What explains the joint existence of two different coordination mechanisms?

Coase justified this existence because of the costs of coordination, the enterprise can control coordination costs more than the free-market mechanism, through the hierarchical coordination mechanism of authority, as the general environment (Dennis Carlton, p68), in which the human factor who makes the decision to resort to concluding contracts in the market is present leads to costs that the enterprise can control through its hierarchical internal environment.

According to Ronald Coase, market transactions are costly, due to three factors (Bouthiba Abderrahmen, op cit, p50) :

- ✓ The market conditions for neoclassical theory are ideal and in reality the markets are monopolistic.

- ✓ limited rationality.
- ✓ Opportunism.

These three factors generate costs for market transactions that the dealer in the markets is forced to bear, and this is contrary to the principle of rationalization, so why are dealers forced to pay costs that they can avoid by resorting to the hierarchical, authoritative mechanism of enterprise coordination.

4- The approach of Oliver Williamson: the institutional coordination mechanism in relationship governance.

Williamson emphasized that the cost of market exchanges drives enterprises to vertical integration, where he specifies in detail the factors that lead to the increase in the relative costs of market exchanges then move to the integration option. Williamson concentrate especially on human factors that works with the environmental factors to explain the market failure in controlling transaction costs, and in contrast to the standard assumptions of traditional economics, some human characteristics that are usually negligible may be the most important in increasing market transaction costs then he mentioned: (Lehmann Ortega et autre, p196)

- ✓ Opportunism (the tendency to cleverly take advantage of profitable opportunities).
- ✓ Limited rationality (the inverse proportion between human capabilities and the size of the problems of market transactions).

These human factors interact with environmental factors such as uncertainty and the small number of transacting parties in relation to the exchanges volume, which leads to market failure and the substitution of market coordination by internal institutional organization.

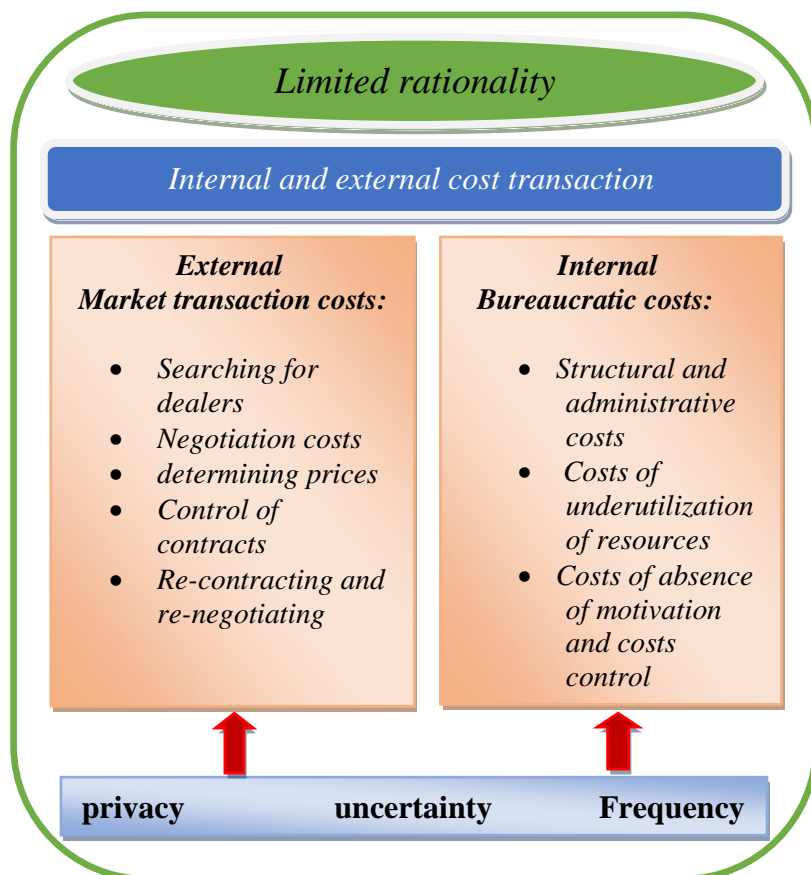
A- The role of integration strategy in controlling market coordination costs.

The integration option eliminates the following costs: (Olivier LAVASTRE, 2001, p19)

- 1) The costs of investing in private assets.
- 2) Post-purchase evaluation costs related to transaction ambiguity.
- 3) The costs of moving to a second opinion.
- 4) Costs of the supplier's opportunistic behavior.

- 5) Costs resulting from the monopoly position of the supplier.
- 6) The costs of limited rationality, and the inability to be familiar with the various alternatives.
- 7) Costs of negotiation, control and transaction implementation.
- 8) Costs of opportunistic behavior before the transaction.
- 9) Costs of post-transaction opportunistic behavior.
- 10) The costs of third-party arbitration.
- 11) Information costs.
- 12) Experience costs.
- 13) Costs of behavior.

Figure 02 : Integration and Non-Integration: A Transaction Cost Theory Model.



Source : Lehmann Ortega, Leroy, 2013, p196 .

From the above it is clearly that the theory of transaction costs was concerned with the enterprise as a coordination mechanism, as a governance structure and penetrated the internal depth of the enterprise to understand this structure, and also indicated the option of integration.

B- The coordinating institution for the governance of relationships between its activities.

Williamson tried to integrate between two new economic fields that are **the institutional economics** and **the new economics of organization**, then he tried to push the research from the enterprise's approach as a productive function - technological construction - to the enterprise's approach as a governance structure - structural building – (Oliver e.willamson, 1998, p23).

The theory of transaction costs does not view the enterprise as a productive function but as a governance structure, and in fact, the governance structure according to this perspective considers it as a mean of order execution in the relationships in which the potential conflict threatens to decline or corrupt the chances of achieving mutual gains (Oliver e.willamson, 1998, p37).

The enterprise is not the only governance structure, but it differs from the markets in the following points:

1. Administrative Control: Enterprises are supported by a wide range of administrative procedures and controls.
2. Adaptation: Adaptation in markets is subjectively “**autonomous adaptation**”, while in enterprise it is collectively “**cooperative adaptation**”.
3. Contracts Law: Contracts law in the marketplace is legal and depends on the court order, while the enterprise replaces the court and relies on self-settlement of conflicts. In the end, the enterprise is the special court itself (Oliver e.willamson, 1998, p38).

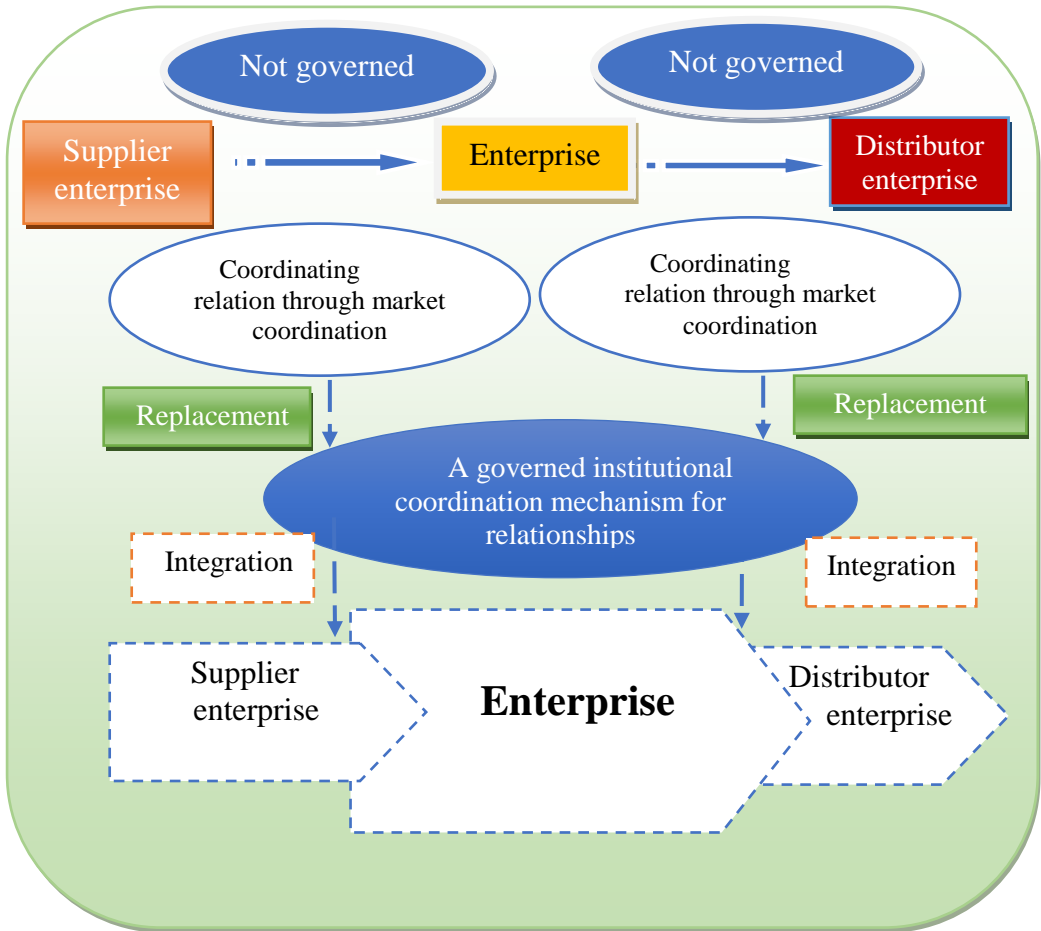
Temin believes that vertical integration means "the limitation of contractual and market exchanges and replace them by internal exchanges within the enterprise's boundaries" (*Fiona Roder,2007, p39*).

Williamson has expanded in analyzing transaction costs to use Simon's limited rationality assumptions in contracts. Incomplete contracts in the markets that regulate relationships between dealers who operate according to the principle of limited rationality rather than the principle of maximization lead to the emergence of opportunist behavior and here “**the hierarchical solution**” is preferred (Samy Jost,2004, p03-91).

5. The coordinating enterprise for the governance of relationships between integrated enterprises.

From what we have seen before, it is clear that the theory of transaction costs has deepened in the internal depth of the enterprise to show its coordination mechanism that include the governance of the relationship between its activities, and the option of integration to ensure the expansion and sustainability of this coordination mechanism, and here we would like to move to highlight on the governance of the relationship between the enterprise and the integrated enterprises, this what is shown in the following figure :

Figure 04 : Hierarchical coordination mechanism for the governance of relations between enterprise, suppliers and distributors.



Source: done by the researcher.

Transforming the relations between a supplier enterprise, an enterprise, a distributor enterprise, from coordination between them through the market coordination mechanism, that is mostly not governed because of its free coordination mechanisms, which produce a large number of alternatives that the contractors cannot be familiar with, and which results in what Ronald Coase and Olivier Williamson called opportunistic behavior that greatly affects the relationship governance between the two contractual, to relationships coordinated through the hierarchical coordination mechanism dependent on the hierarchy of authority governing these relations between the three.

*An introduction to the governance of inter-organizational relations
within the context of transaction costs theory.*

The institutional coordination mechanism can govern the relations between the three integrated enterprises through the following:

➤ **Administrative Control:**

The enterprise can govern the relations between itself and the other bilateral - a supplier and distributor enterprise - through its oversight mechanism greater than market control mechanisms, the administrative procedures and controls provided by the enterprise that coordinate relations make them more governed.

➤ **Adaptation:**

The relations between the trio can become more governed through the ability of the coordinating enterprise to transform self-adaptation in markets into cooperative adaptation between the three integrated enterprises.

➤ **Reducing opportunistic behavior:**

The coordinating enterprise can make relationships more governed, by limiting market opportunistic behavior through the most stable, more informative, and more secure internal environment for fair transaction returns between the three integrated parties.

➤ **Provide control and coordination** (Bouthiba Abderrahmen, 2017, p118)

In the case of integrated enterprises, the costs of scheduling and coordinating operations and responding to emergencies can be low that makes the slowdown in work decreases and the ability to facilitate delivery increases which improves control in production, delivery and maintenance dates.

➤ **The stable relationships:**

The pre- and post-production phases, upon realizing the stability of the buying and selling relation, may be able to develop more efficient and specialized procedures for dealing one of them with the other, unlike the relationship with the independent supplier or customer where the seller and the buyer face in the transaction the costly competitive risks of abandoning or pressuring one of the parties to the other. This stability allows products to be adapted at a lower cost in the case of integration than in its absence

which requires payment of risk premiums which raises costs and affects the governance of relations between the trio.

➤ **Make relationships more solid, and less flexible:**

Integrated enterprises support their competitiveness by strengthening entry barriers to competitors, as well as lifting exit barriers, and making the enterprise in an "economic independence", so the enterprise is now independent with its internal transactions.

➤ **Diversifying the business of integrated enterprises:**

Because it leads the enterprise towards a new pair of business / missions (métiers / missions), diversifying the enterprise's business leads to independent resources and competencies, different organizational cultures, and ultimately different management requirements, which increases the governance of relations between the enterprise and other enterprises that share with it in this new pair.

➤ **Transforming commercial relationships into internal ones:**

The integrated enterprises transform the previous market trade relations into internal controlled relationships, enabling them to have internal control over the forces of supply and demand.

The hierarchical coordination of the relations between the trio, enables each enterprise to redraw its borders by transforming them to market transactions subject to free logic, the logic of supply and demand and coordinated through the price mechanism, into internal transactions coordinated by the authority of the managers of integrated enterprises, unifying the fate of the enterprise and its suppliers and distributors by making it under a unique strategic direction, that supports its competitiveness, makes it more influential in the markets, less affected, and makes relationships more governed.

5. CONCLUSION

In conclusion, we tried to highlight the transaction costs theory, through Ronald Coase's contributions in showing that the enterprise exists because it has a hierarchical coordination mechanism, which differs from the free market coordination mechanism dependent on the forces of supply, demand and prices then we tried to expand further in explaining the mechanisms of

the institutional coordination mechanism's work then we have seen the contributions of Oliver Williamson in clarifying the role of this mechanism in the governance of transactions, and then addressing the option of integration to ensure the expansion and sustainability of this mechanism, here we tried to drop the approach of the transaction costs theory on the relationships between the three integrated enterprises, so we reached that the enterprise as a coordination mechanism can govern the relationship between itself and the supplying and distributing enterprise.

5. Bibliography List:

- *Ghertman Michel, 2010, Oliver Williamson : un Nobel pour l'économie et la gestion, Revue française de gestion, 2010/1 n° 200.*
- *Adolf Berle Gardiner Means, 1932, Quelques controverses théoriques L'entreprise dans la théorie économique, Comprendre l'économie vol. 1.*
- *Coase R.,1937, The Nature of the Firm, Economica, New Series, Vol. 4, No. 16.Coase Ronald, ébid.*
- *Bouthiba Abderrahmen, 2017, Implementing of cost control strategy to support the competitiveness of Algerian industrial enterprises, Unpublished PhD thesis, Hassiba Ben Bou Ali university, Chlef, discussed on 07/02/2017, algeria.*
- *Mohammed Chahata Khettab, 2010, Integration between cost management tools and corporate government A proposed framework: A theoretical and case study, The Twelfth congress on Methods of Accounting Development in the Kingdom of Saudi Arabia.*
- *Dennis Carlton, Jeffrey Perloff, 2008, Economie industrielle, 8 éditions, de Boeck, France.*
- *Lehmann Ortega and beranard garrette and pierre dussauge ande rodolphe durand,2013, Strategor, 6 éditions, Dunod, France.*
- *Olivier lavastre, 2001, Les Coûts de Transaction et Olivier E.Williamson :Retour sur les fondements, Xième Conférence de*

l'Association Internationale de Management Stratégique, Université Laval Québec, 13-14-15 juin ,canada.

- *Oliver e.willamson, 1998, transaction cost economicsMhow it works, where it is headed, de economist, 146,no.1*
- *Fiona Roder, Strategic Benefits and Risks of Vertical Integration in International Media Conglomerates and Their Effect on Firm Performance, Dissertation to obtain the title of Doctora economic, St. Gallen University,Germany, 2007, P 39.*
- *Samy Jost, La théorie des coûts de transaction de Williamson et la surveillance des banques dans l'UE,2004, euryopa vol. 27-2004.*
- *Bouthiba Abderrahmen, ibid, p118.*