ON SIGNIFICANCE OF TRANSACTION COSTS IN INSTITUTIONAL ECONOMICS

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Institutions and institutional arrangements cannot "work" by themselves, meaning without necessary efforts – considered costs in economics - for preserving and improving them. Legal institutions and rule of law are based on systemic efforts needed to apply the ethical rule, actions that mean, in their turn, certain costs. These efforts that facilitate social cooperation process represent, for many economists, the costs of economic system functioning. In nowadays institutional economics, these costs of economic system functioning are called "transaction costs". This paper aims to offer a critical point of view on significance of transaction costs in institutional economics.

Institutions, human action and transaction costs

In the institutional approach of Douglass North, Nobel laureate in 1993, the theory of institutions "is constructed from a theory of human behavior combined with a theory of the costs of transacting" (North, 1990:27). By combining these theories, one can understand why institutions exist and what role they play in the functioning of society. North also mentions that if you add the theory of production, one can analyze the institutions implication over the economic performance.

With no intention to underestimate the role of social institutions in the reduction of uncertainty, I will try to emphasize the *irrelevance of transaction costs criteria, as objective sources of valuation of the institutions efficiency*. Also, I will emphasize the implications of institutions utilitarian approach over the economic science and public debates on politics.

The economics of transaction costs begin with "The Nature of Firm", the famous article of Ronald Coase from 1937[1]. The Nobel laureate Ronald Coase explain the existence of the firm and the integration of the activities from this kind of organizational structure using the transaction cost concept (the cost of running the price system, in original terminology). But, as Oliver Williamson shows (1991:8), "one could say that Coase's approach on the transaction costs did not face time as well as the theory [of firm], on the whole". Coase neither defined in "The Nature of the Firm" the empiric character of transaction costs, nor explained how these could be recognized. Despite of all contradictions regarding the transaction costs, this theory represents today the corn stone of efficiency analyses over comparative institutional arrangements.

The economic theory reveals the universal fact that any human action entails a cost, as human action means choice, and so sacrifices and opportunities forgone. Accordingly, doing a transaction has a cost; conceptual, the transaction cost phenomenon becomes

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[1] Ronald Coase, "The Nature of the Firm" [1937] in *The Firm, the Market, and the Law*, Chicago: University of Chicago Press, 1990, pp. 33–56.

easily to be accepted. The major difficulty refers to these costs becoming operational. So, it can be said that transaction costs represent more a way of giving arguments than an efficiency indicator, of empiric nature. The confusion derives from the fact that transaction costs are considered an indicator used in order to appreciate the superiority of institutions and institutional arrangements.

For example, for North, the information costly character represents the key of transaction costs:

„The costliness of information is the key to the costs of transacting, which consist of the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements. These measurement and enforcement costs are the sources of social, political, and economic institutions" (North, 1990: 27).

On the whole, in transaction costs category the economists include information costs, negotiating costs and those of writing contracts, the costs of protecting property rights and those of enforcement rules and agreements from different contractual arrangements. The problem of "measuring valuable attributes of what is changing" reveals the objectivist perspective on which North (1990:27) built his theory. But the subjectivist paradigm, on which the entire modern theory of value is built on, excludes any possibility of objective valuation (external one) for costs involved by human action, as a choosing process.

The real foundations of economic science are built on theory of opportunity cost. This theory does not prescribe a specific type of cost, but an economic way of thinking through which individuals' behavior in society is explained. In fact, the central argument comes from the very simple idea that the cost phenomenon derives naturally from human action, which means choice and exchange. So, the cost's significance is the satisfaction forgone (the value of the best sacrificed opportunity – as economics textbooks show).

Economic science learns us too that valuations that determine human choices are, necessarily, *ex-ante* and subjective economic categories. These valuations represents the importance, utility or value that individual gives to goods and events taken into consideration. Today, despite many inconsistencies in *mainstream* economics, the theory of subjective value is the corn stone of economic science, as demonstrated over more than a century by economists of Austrian School[1]. For example, in one of the most cited paper dedicated to the economic theory of the cost, the Nobel laureate James Buchanan emphasize too that *all costs that influence our decisions are always subjectivist valuations reported to potential opportunities*[2]. The source of these conclusions derives from the economic way of thinking of the Austrians, Ludwig von Mises and Friedrich von Hayek, whose influence over researches of L.S.E. (London School of Economics)

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[1] In his *magnum opus* "Human Action", Ludwig von Mises show that "value is the importance that acting man attaches to ultimate ends. Only to ultimate ends is primary and original value assigned. Means are valued derivatively according to their serviceableness in contributing to the attainment of ultimate ends. Their valuation is derived from the valuation of the respective ends. They are important for man only as far as they make it possible for him to attain some ends. Value is not intrinsic, it is not in things. It is within us…" (p. 102).

[2] James Buchanan, *Cost and Choice: An Inquiry in Economic Theory*, Markham Publishing Company, Chicago, 1969; James Buchanan şi G. F. Thirlby (eds.), *L.S.E. Essays on Cost*, Willmer Brothers Limited, Birkenhead, Great Britain, 1973.

was a significant one[1].

Cost (including transactions costs) analyze has to start necessarily with emphasizing the distinction between the measurable *objective* cost (the accountancy cost) and the cost as subjective essential element for the choice process (the economic cost). Within the neoclassical theory, the cost has a material dimension, being not presented through the distinction *ex ante – ex post*. The formal theory of human action is based on the recognition of the fact that cost phenomenon (impossible to be separated from choice process) has a subjective dimension when speaking about utility. This perspective reveals insuperable difficulties when making transaction costs operational and when appreciating their influences. Murray Rothbard pointed out about the nature of the cost when he wrote the followings:

„But if costs, like utilities, are subjective, nonadditive, and noncomparable, then of course any concept of social costs, including transaction costs, becomes meaningless. And third, even within each individual, costs are not objective or observable by any external observer. For an individual's cost is subjective and ephemeral; it appears only *ex ante*, at the moment before the individual makes a decision. The cost of any individual's choice is his subjective estimate of the value ranking of the highest value foregone from making his choice" (Rothbard, 1997, 269).

Despite of these arguments against the possibility of making transaction costs operational, almost all approaches on institutional economics use transaction costs as criteria for efficiency of institutions. For example, inefficiency is explained by high transaction costs, assimilated to a presumed failure for the parts of an exchange when trying to obtain information over the exchange terms. The secret of obtaining efficiency could be decreasing of transaction costs – the Ronald Coase famous idea:

„The argument has proceeded up to this point on the assumption . . . that there were no costs involved in carrying out market transactions. This is, of course, a very unrealistic assumption. In order to carry out a market transaction, it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost". (Coase 1990, p. 114)

The conclusion could be that, if potential exchange parts can be better informed or more able to communicate one to another, then it won't be unconsumed exchanges and looses over the property rights value. But, this perspective involves difficulties impossible to be overcome. For the external observer, *the existence of unconsumed exchanges does not reveal, necessarily, lack of information and communication* or institutional

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[1] In "The Essential von Mises" (1973, http://www.libertarianpress.com/rothbard/essential/toc.htm), Murray Rothbard show that although untranslated until well after World War II, "Mises' ideas on methodology were brought to the English speaking world in highly diluted form by his student and follower at the time, the young English economist, Lionel Robbins. Robbins' *Essay on the Nature and Significance of Economic Science* (1932) in which the author acknowledges his "especial indebtedness" to Mises, was acknowledged for many years in England and the United States as the outstanding work on the methodology of economics.

inefficiency. The real problem consists in the difficulty to reveal the existence of transaction costs and also the impossibility of measuring these costs[1]. On the other hand, the implications of the entrepreneurship over institutional change process must be taken into consideration. Let us presume that actual institutional arrangement does not reveal, through market process, the "relevant knowledge" form hayekian approach. So, initial institutional arrangements are appreciated to be "inefficient". But, in this conditions, the entrepreneurial process will generate institutional change, on "*the human action, but not human designed*" model.

Let us consider the following example: there are two villages, Ronald and Coase, which does not communicate with each other. In the first village, two pheasants are exchanged for a beaver. In the other village, two beavers are exchanged for a pheasant. In isolation, as there is free exchange in both villages, the result of this allocation can be considered efficient. But isolation cannot provide the maximum advantage of the deepened division of labour and extended commerce, generated through exchanging on the market of the two villages. In this circumstance, the entrepreneurial activity will seek for the benefit of the unvalued opportunities of this inefficient arrangement which will sooner or later, generate the exchange between the two villages.

Anticipating price discrepancies for the same product, as in the previous example, indicates the existence of profit opportunities (incorporated in the price structure). These opportunities will enhance entrepreneurship, which will adjust the inefficiency of isolation. Profit opportunities stimulates the entrepreneurship, which can, thus, improve the efficiency of allocation process. As a consequence, the institutional constraints and incentives will be restructured and the communication and informational environment improved.

On free market, entrepreneurship is not just the result of existing institutions, but it itself creates new institutional constraints and unblocks organizational inertia[2]. So, entrepreneurship can be considered a fundamental source of institutional change, not just its catalyst, as it appears in North approach[3]. As Israel Kirzner argues, the profit

[1] Despite the fact that cost and choosing theory has especially subjective foundations, I emphasize North's empiric trying of measuring transaction costs. According to a research done with Wallis (1986), in the United States economy, more than 45% from national revenue is represented by transactions allocated resources. On this analyze basis, the authors emphasize the transaction costs and services aria' increasing dimension within the analyzed period (1870 – 1970). So, I intend to introduce an alternative approach: transaction costs do not represent exclusively the reflection of the exchange barriers. They represent, too and probably in a more important sense, the existence of greater profit opportunities (exchange ones). So, transaction (co-ordination) costs' increasing dimensions represent the institutions and institutional arrangements' result itself, presented within labor division and exchange process. Increasing the relative dimension of transactions within services area represents the mechanism of transaction costs' attenuation and also the mechanism of revaluation as much exchange opportunities as possible.

[2] See, for this the institutional reforms developed in China, generated by the entrepreneurship, which have became a factor of political pressure, directed toward the relaxation of formal legislation in business.

[3] Simply by conforming to the institutional constraints, the creative and the anticipative ability of the entrepreneurs will be completely ignored. This is why an entrepreneurial approach of institutions is necessary.

opportunity existing on the free market, sustains competition: "*…if the greatest entrepreneurship talent is insufficient for removing all "misallocations", even giving the profit reason, then the rest of "misallocations" are simply undetectable*[1] *(*the "misallocation" term is used by Kirzner referring to an allocation inefficiency, to a presumed individual plans lack of co-ordination).

According to the above mentioned example, it is exaggerated and unfair in the mean time, to suggest that the initial institutional arrangement (isolation of the two villages markets) prevent efficient allocation because of the transaction costs' barrier. Free exchange means including entrepreneurship efforts of obtaining all possible exchange earnings, which means recognizing the existence of informational and communication constraints permanent restructuring. If present constraints are artificially imposed, politically or through administrative rules, entrepreneurship that may generate exchange barriers optimal restructuring, cannot be stimulated or can even been stopped. On these artificial constraints conditions, which do not allow volunteer agreement over property rights involved, the allocation frame can be labeled, shows Buchanan (1985:98), as "inefficient".

Transaction Costs Relevance for Institutional Efficiency

Free market represents a voluntary exchange system of legitimate private property rights. Its dominant rule is unanimity. On the condition political constraints are absent, the market process restructures behavior rules, constraints and institutional stimulants and so encourages the exchange. *Well defined and sure property rights are much easier to be exchanged than the insufficient defined and uncertain ones*. This does not demonstrate the fact that the exchange external observer can indicate the real nature of the exchanges' difficulties or measure the transaction costs' decreasing dimension, as an institutional efficiency appreciation instrument. On the other hand, transaction costs (the cost of using pricing system in Coase's terms) can be presented as production costs' expansion, more or less important, taken or not into consideration, depending on perceptions and subjective valuations of those involved in the market process.

The fundamental problem will be formulated as it follows: *which is the relevance of transaction costs for the methodological corpus of economic science? How can transaction costs be compatible with* subjectivism (the one the theory of cost is founded on) *and with free market* (as an institutional arrangement, which excludes the relations of power)*?* Entrepreneurial approach reveals that on free market transaction costs cannot be more than conceptual/linguistic innovation, of no scientific importance.

Within free market private economy, resources are allocated on commercial bases to information production and selling direction: business consulting agencies, real estate agencies, different services offices, etc. are *organizations involved in services and information production*. Great competition and legal practices in contracts area are important sources of transaction costs reduction (for example, generalizing standard contracts and "commercializing" them and consolidating goods such as *trust*, *good reputation*), too.

[1] Israel Kirzner, *Market Theory and the Price System*, Princeton, New York: Van Nostrand Co., 1963, p. 304.

The central argument of Ronald Coase's essay "The Problem of Social Cost" (1960) is the fact that volunteer exchanges, on the condition property rights are well defined, represent the sufficient condition of efficiency[1]. But Coase completes this proposition by the so called "*zero transaction cost*" clause. The approach aims to suggest that, on the condition there are zero transaction costs (which means lack of uncertainty), resources efficient allocation does not depend on initial definition of property rights. As a paradox, this clause is the one that weakens Coase's arguments. Coase's approach gained a lot of laudatory comments, but also contradictory ones and scientific critics from great academic personalities who indicated grave errors about what is wanted to be "law and property rights' economics" [2].

As Buchanan (1985:93) shows, it is unhappy that Coase presents his arguments in terms of *cost-benefit relation independent determined and measurable supposed.* In Coase's examples these relations are the same in all involved parties perception. So, the "unique" resources allocation exists and become conceptually undeterminable for every external observer. On the other hand, "zero transaction costs" hypothesis make resources allocation not to be influenced by property rights structure. In this case, the structure of property rights is of no interest.

This kind of arguments reveals that the economic analysis *á la Coase* cannot establish a scientific criterion for economy of law or for private property rights; as well, it cannot create an adequate medium for the positive approach of the economic science. Furthermore, the impossibility of measurement of transaction costs reveals their irrelevance for evaluating the efficiency of the exchange, or for the efficiency of the alternative structures of property rights.

In a fundamental manner, it is argued the unrealistic character of the hypothesis used by Coase. The costs that we deal with in economic science — opportunity costs — are a real-world phenomenon. Real-world behavior results from choices and that to choose means to do something and not to do other valuable things that could have been done instead. The costs of real-world behavior are the values of such real alternatives. But transaction costs as Coase understands them can only be defined in terms of "alternatives" that have never been open to human beings and which never will. To be a human being means to act under uncertainty. This fact permeates all aspects of human behavior. It is therefore meaningless to hold up perfect foresight as a standard in terms of which real-world human action appears to be costly.

Hülsmann (2004:50) pointed out about irrelevance of Coase's hypothesis:

"We do not wish to insinuate that it is useless to compare our real world with fictitious other worlds. The point is to be careful in defining and using fundamental

[1] Within externalities theory frame, Coase argues that free exchange between parts shows that all Pareto-relevant externalities tend to be eliminated.

[2] I mention here some of most critical replies against "*The Problem of Social Cost*" and Coase's economic analyse of the law: Walter Block, „*Coase and Demset on Private Property Rights"*, Journal of Libertarian Studies, I, nr. 2, 1997, p. 111-115; Robert Cooter, „*The Cost of Coase*", Journal of Legal Studies, XI, 1982, p. 1-34, Murray N. Rothbard, „The Myth of Efficiency" şi „Justice and Property Rights" în *The Logic of Action: Method, Money and Austrian School*, 1997, p. 269-297, „*Law, Property Rights, and Air Pollution"*, Cato Journal, 1982, p. 58-59; Gary North, *The Coase Theorem. A Study in Economic Epistemology*, Institute for Christian Economics, 1992, James M. Buchanan, *Liberty, Market and the State*, 1985, p 92-107.

concepts lest we invalidate analyzes of the real world. The cost concept underlying Coasian transaction costs has nothing to do with the opportunity costs that we use in economic analysis. Rather, transaction costs have affinities with what a distinguished follower of Coase has called "the nirvana approach"[1] - identifying "inefficiencies" in our world through comparisons with a perfect-foresight nirvana. This is a deficiency that vitiates Coasian explanations of the emergence and transformation of social institutions".

So, it is misleading to say that those practices and institutions spring from a special type of "costs" – transaction costs. And it is wrong to infer that one can explain the evolution of those practices and institutions in terms of transaction costs. Explanations that rely on the nirvana approach can be more or less exciting literature, but they add nothing to science. Valid explanations of human action and human institutions must stress real-world choices among real-world alternatives. This approach too has been known before 1937. It is called methodological individualism.

If the entire coasean approach is analyzed in the meaning of the methodological individualism, then there is no way to determine the identical character of the exchange for all parties involved. If person A refuses an X $ offer for good T, then one can suppose that person A considers that good T has a greater value than X $. In a certain institutional frame in which A and B are parties of a potential exchange, the absence of exchange reveals that T remains in its most valuable utilization. Therefore, in a given institutional environment, resources will be efficiently allocated as long as the parties involved are free to participate or to refuse the exchange[2].

What happens when, for example, the legal system institutes property rights over land, but not as well over transacting them? In this circumstance the coasean economist will blame transaction costs – their increasing being synonymous with a greater inefficiency. Actually, inefficiency is the result of altering property rights, through interference of the political system, which obstructs the market in creating prosperity. Thus, it would be a glaring mistake to explain the perpetuation of poverty for a major part of people through high transaction costs. It would mean to ignore the inability of legal and judicial systems to protect property rights; the alteration of productive incentives through major governmental interference with the market; the distribution of privileges on the *rent-seeking* channel of the democratic "*game*", meaning the pattern of an institutional arrangement totally opposite to the principles of economic development.

The market process cannot develop into an institutional vacuum. Any resources allocation is necessarily influenced by the structure of rules and rights, defining the institutional environment in which the decisions of evaluating and using resources are taken. Naturally, resources have a different allocation, in different institutional arrangements. But this means nothing more then the fact that people act different under

[1] Demsetz, (1969). To avoid misunderstandings, let us emphasize that our present criticism concerns only the concept of transaction costs. Coase's precept for judges and legislators — maximize social product, minimize social costs — is coined in terms of relevant alternatives and thus avoids the nirvana fallacy. As I have argued above, however, this precept suffers from other grave shortcomings.

[2] Given other conditions then the free market, the judgment of transaction cost – as an obstacle for the exchange – could obtain an intuitive significance, which would consist in appreciating institution's ability to favor social cooperation and prosperity. Every governmental policy is defined through exerting coercion over certain categories of persons.

different structures of constraints and incentives. As a result, the structure of property rights – the institutional environment – cannot be a neutral one.

In the world of Coase, in which there are no transaction costs, the allocation of resources will not be altered by the structure of property rights. This famous idea is as useful as the fact that in Eden all people are omniscient. In the real world, the other aspect becomes true: when transaction costs are positive, the allocation of resources is altered by the structure of property rights. In the virtue of this conclusion, transaction costs turned into the paradigm of institutional economics. For the economists of Chicago School, *efficiency* is the criterion for institutional solutions. This way, the ethics of private property have tenuously been substituted by the *cost-benefit* criterion. From such an utilitarian approach it arises the ill-fated "*need*" for law as an instrument of maximizing the *social wealth:* it is what the judge Richard Posner argues in its works (1983).

The corollary of Posner approach is that on the condition of high transaction costs (I wonder who establishes what high or low transaction costs means?), will efficiently result when the court will offer the rights to the one who will evaluate them in the highest degree[1]. According to Coase (1991:253) "*it is obviously wishful that the rights should be distributed to those who can use them at their highest efficiency, and for achieving and maintaining such a distribution, the cost of transfer for these rights must be minimal and the law must favor its achieving*". In this approach Coase and Demsetz pleads for "*the allocation of property rights in any structure which will minimize the social transaction costs*". In other words, if by aggregating individual costs and incomes it is obtained a "*social net income*", then the policy which created this income is desirable, no mater the degree of coercion. It reflects the unfortunate aspect that for Coase (1990:15), "*the economic problem, in every case of negative economic* [externality] *effect, is maximizing the value of production*". This view clearly indicates the subordination of private property ethics in favor of arbitrary considerations over their efficiency.

The subjectivism of efficiency, as well as the impossibility of interpersonal comparison of utility, demonstrates why efficiency can't be a scientific criterion – especially in evaluating law, property rights or state policy. Something else must be the reference point for social science[2]. Even though, there is a general understanding – through economists – that individual utilities cannot be measured, and thus compared, they still sum up and subtract "*social benefits*" and "*social costs*". As a proof for this statement are standing the analyses of "*scientific evaluation*" of benefits and loses in welfare for the entire society, for the "*national economy*". Moreover, there is the amount of studies such as: "*The costs and benefits of Romania's accession to UE*", in which it is of little importance that economists have "their hands bound" in measuring and

[1] For Posner (1983), "*this is the economic reason which entitles the worker to sell his labour, and the woman to chose her sexual partners*", which means the impossible perspective for establishing rights according to the intensity of their evaluation (the efficiency criterion), not on reasons regarding the ethics of private property.

[2] In "*The myth of Efficiency Criterion in Economic Science*" (Marinescu, 2005), I argued that the only and fundamental criterion which can confirm the scientific nature of economy, is the criterion of "ethics". The economic judgments are complete when there are placed in an ethical environment, as long as law and ethics are naturally connected and the essential means for a right understanding of human nature.

comparing advantages and costs (especially because these belongs to someone else). What remains is purely political speculation.

Finally, Coase, Demsetz and Stigler's studies postulate an epistemological mistake, in concluding that the distribution of property rights, in circumstance of positive transaction costs, must be subordinated to the criterion of monetary value maximization of "social" production. In fact, the cost–benefit criterion ruins the entire coasean theory, when the one "negotiating" the negative externalities that are imposed to him, will shout – as Gary North did (1992:79): "*Coase, get your cattle off my land!*"

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