



AMBO UNIVERSITY
WOLISO CAMPUS
SCHOOL OF GRADUATE STUDIES
COLLEGE OF BUSINESS & ECONOMICS
INSTITUTIONAL ECONOMICS
LECTURE 2
TRANSACTION COSTS

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Lecture content

1. Transaction costs
2. Contract enforcement and property rights
3. Enforcement mechanisms
4. How to reduce transaction costs?
5. Transaction Costs and Linkage Mechanisms

Transaction costs

- A small or even unobserved change in transaction costs can lead to dramatic changes in productivity or in the structure of organizations (*Adam Smith, Ronald Coase*).
- “the costliness of information is the key to the costs of transacting” (North 1990).

Transaction costs...

- Steps in the contracting process:
 - ✓ searching
 - ✓ Screening
 - ✓ Negotiating
 - ✓ Monitoring
 - ✓ Enforcement
- These all steps involves time and cost.

Transaction costs...

- Additional transaction costs:
 - ✓ Credible commitments
 - ✓ Transaction losses and/or renegotiation
- If transaction costs are too high, no transaction will occur!

Transaction costs...

- Let us differentiate transaction cost from transformation cost.
 - ✓ Transformation costs = costs of production
 - Land, labour, capital
 - ✓ Transaction costs = “the costs of doing business”
 - ✓ Transaction cost arise due to the existence of institutions (imagine steps you need to pass through to get your trade license renewed!)

Transaction costs...

- Why most formal commercial banks fail to outreach their financial services to the rural communities in the Ethiopia?
- How microfinance institutions evolved?

Transaction costs...

- In rural areas:
 - ✓ People live scattered.
 - ✓ Covariant risks are high.
 - ✓ Transaction costs of doing business high?

Transaction costs...

- Rural microfinance:
 - ✓ largely high transaction costs (staff time, transport).
 - ✓ Searching,
 - ✓ screening (training)
 - ✓ Processing applications,
 - ✓ record keeping
 - ✓ Repayment visits (monitoring, enforcement)

Transaction costs...

- Why do MFI prefer group lending to individual lending?
- Why do MFI prefer female clients to male clients.
 - ✓ Which reduces transaction costs: group/individual lending? Female/male clients? Why?
 - ✓ Consider difference in self-assertiveness and cooperation between male and female!

Transaction costs...

- ❑ Preference to group lending because:
 - ✓ To ensure regular repayments,
 - ✓ To create group liability,
 - ✓ To reduce transaction costs.

Transaction costs...

- Why smallholder farmers are mostly underserved by financial institutions?

Transaction costs...

- Neither group liability nor regular repayments work well for seasonal agriculture
 - Covariant risk, seasonality
- Transaction costs and risks are prohibitive!
 - Micro-finance does not serve most smallholder farmers in most parts of Ethiopia
(no transactions occur?)

Contract enforcement and property rights

- *The inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the third world (North, 1990).*
- Development entails move to longer-distance, more complex trade
 - From personalized to impersonal?

Contract enforcement

- Institutions must evolve to support this by keeping transaction costs down.
- Contract enforcement is critical: protecting property rights during transactions.
- Call from informal to formal institutions?

Contract enforcement

- Reliance on courts is expensive!
- Must complement with other mechanisms
 - Informal institutions?
 - ✓ Consider the share cropping and land rental agreements among the smallholder farmers in Oromia.
 - ✓ Read the federal *Rural Land Administration Proclamation (1997)* and *Oromia Rural Land Administration Proclamation (2007)*

Contract enforcement

- Consider also food grains trade in Ethiopia:
 - ✓ Prices are not publicly announced.
 - ✓ Goods are highly differentiated.
 - ✓ no formal grading system.
 - ✓ Variable weights.
 - ✓ Contracts are oral and non-standardized.
 - ✓ Little inspection or certification.
 - ✓ No recourse to legal means of contract enforcement.
 - ✓ Too slow, expensive, corrupt .

Contract enforcement

- The Effects?
 - Both producers and traders are highly vulnerable to being cheated with respect to:
 - ✓ Market prices
 - ✓ Qualities
 - ✓ Quantities
 - ✓ Timing of delivery
 - ✓ Product spoilage or loss during transport

Contract enforcement ...

- Uncertainty and imperfect information.
 - ✓ Genuine problem or opportunistic behavior?
- Risks discourage trade and investment
 - ✓ Thin markets
- Discourages production,
- Economic stagnation?

Enforcement mechanisms

- Relational contracting:
 - ✓ Repeated dealings.
 - ✓ Bilateral reputational investments: serve as collateral against opportunism or credible commitment.
 - ✓ Trust

Enforcement mechanisms...

- Multilateral punishment strategy (collective action)
 - ✓ Within trading networks
- Third party enforcement (public or private)
 - ✓ Requires that information on behavior is readily available in a transparent way.
 - ✓ Deals are large enough to justify costs of recourse to third party enforcement.

Enforcement mechanisms...

- Moral authority
 - ✓ Strong and widespread adherence to norms
- New forms of reputational mechanisms
 - ✓ Branding (multilateral reputational investment?)

How to reduce transaction costs?

- Transaction costs are low when these conditions exist:
 - ✓ Organizations are exchanging non-specific goods and services-mass production
 - ✓ Uncertainty is low.
 - ✓ There are many possible exchange partners.

Transaction Costs and Linkage Mechanisms

- Bureaucratic costs
 - ✓ According to transaction cost theory, organizations will adopt increasingly formal linkage mechanisms with their exchange partners as transaction costs increase.
 - ✓ But these mechanism also carry bureaucratic costs within the organization.

Transaction Costs and Linkage....

- Transaction cost theory can be used to choose an inter-organizational strategy (vertical integration, horizontal linkage?).
- Managers can weigh the savings in transaction costs of particular linkage mechanisms against the bureaucratic costs.

Transaction Costs and Linkage....

- Managers deciding which strategy to pursue must take the following steps:
 1. Locate the sources of transaction costs that may affect an exchange relationship and decide how high the transaction costs are likely to be.
 2. Estimate the transaction cost savings from using different linkage mechanisms.
 3. Estimate the bureaucratic costs of operating the linkage mechanism.
 4. Choose the linkage mechanism that gives the most transaction cost savings at the lowest bureaucratic cost.

Reading assignment

- Gabre-Madhin, E. (2001). *Market institutions, transaction costs, and social capital in the Ethiopian grain market*. Research Report 124. Washington, D.C.: International Food Policy Research Institute.
- Benham A., Benham L. (2001) 'The Costs of Exchange', *Ronald Coase Institute Working Paper Series, working paper No. 1*

A graphic of a spiral-bound notebook with a brown cover and a light beige page. The spiral binding is on the left side. A horizontal line is drawn across the page, just above the text.

THANK YOU

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