

Transaction cost analysis



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Transaction Cost Analysis as Framework According to TCA, a transaction is the transfer of goods or a service and the analysis of transactions emphasizes on achieving efficiency in their administration (Rindfleisch & Heide 1997). Firm is a particular form of organization for administering transactions between one party and another and is characterized as a managerial hierarchy. In contrast, market governance is characterized as transaction taking place without managerial oversight. Firms exist because they can sometimes reduce the costs of negotiating and enforcing terms and conditions of exchange relative to market transacting.

Transaction costs may consist of ex ante and ex post costs. In the sales service setting, the ex ante costs include the expense of searching for an independent representative and negotiating the price and contract. The ex post costs, such as incompetent sales service (e. g. not meeting sales quota), are incurred after the contract has been signed but before the entire transaction has been completed.

If the cost of organizing an exchange in a market exceeds the cost of coordinating the exchange in a firm, the company may go for in house sales, and vice versa. Williamson's TCA framework rests on two assumptions about human behavior: bounded rationality and opportunism. First, individuals in a company are bounded rational. It is impossible for a man to foreknow all probabilities and matters that will occur in the future. This limitation makes it impossible to structure perfect contracts.

It is also the case that any contract will be incomplete even if all information is available. In fact, environmental uncertainty and behavioral uncertainty

worsen the situation. First, environmental uncertainty leads to difficulties in revising the agreement to fit the changing situation. Second, behavioral uncertainty becomes problematic in evaluating whether the performance adhering to the established agreement (Rindfleisch & Heide 1997).

In short, TCA holds that when uncertainty is high, internalization will be more efficient than market contracting because market contracts will be excessively costly to write, govern, and enforce. Second, individuals behave opportunistically. They will act in “ self-interest with guile” (Howard & Lam 2001). Theoretically, opportunism is inherent in most of the transactions.

Anderson (1988) defines opportunism in sales setting as “ 1. misrepresenting information, activities or efforts (e. g. falsifying call reports); 2. distorting results (e.

g. deliberately selling to questionable credit risks to raise reported sales); 3. misrepresenting intentions (e. g. promising to increase hours worked without intending to do so); 4. misrepresenting selling costs”.

A firm is especially vulnerable to opportunistic behavior when it has imperfect control over sales rep, sales rep has personal interest, and contract with sales rep is incomplete. According to Williamson, hierarchical structure is likely to be preferred under such opportunistic situation. The exertion of legitimate authority over employees, monitoring of behavior and offering of more varied incentives can dampen opportunism. It is therefore clear that the TCA has been used to explain not only the existence of firms but also the scope of firm, in terms of vertical integration.

In-House Selling Agents Decision In house selling agents are the hierarchical governance mode. They are working for the company as employees who are paid by salary or salary plus commission. With the bounded rationality and opportunism assumptions, Williamson suggests that three factors play a fundamental role in determining if market or bureaucratic transaction is optimal. The factors are asset specificity, uncertainty, and frequency of transaction (Davies and Lam, 2001). A) High Degree of Transaction Specific Assets Williamson suggests the most important determinant of vertical integration is transaction specific assets.

Asset specificity can be broken down into physical asset specificity, human asset specificity, site specificity and dedicated assets which have a specific usage and cannot easily be transferred to another use. Performing sales activity does not usually require an investment in physical assets that are specific to the customer, and when it does (such as the rent for product display), the cost is usually billed directly to the company. Site specification is low since permanent co-location of people or other assets is not required. Dedicated assets that cannot be redeployed are uncommon. Obviously, the only aspect of asset specificity that truly affects the decision of in-house sales is the human asset specificity.

Consistent with TCA, Anderson (1985) found that the more the human asset specificity, the greater the likelihood of using direct sales force to hold opportunism in check. Anderson measured asset specificity as the extent of specialization in knowledge or working relationships between the sales and the company or the customer. If human asset specificity is high, then there is significant risk that the outside sales rep will opportunistically try to take

advantage of the firm, a so-called hold up situation (Davies & Lam 2001). In the case of sales of electronic components, Anderson (1985) shows that the decision of establishing in-house sales organizations versus using independent representatives is swayed by the extent of specific sales knowledge and human assets within the cooperation. The more a salesperson possesses human assets, knowledge and relationship, which are specialized relate to the company, the greater the chance for going direct sales.

Under the condition of high human asset specificity, opportunistic behavior can be expected. A situation will be the independent rep holding the company's product and confidential information. Over time, the rep will be able to put pressure on the company to accept a commission increase requested by rep. Although the company can change rep, the specialization aspects of rep's sales service create switching costs for the firm of changing rep. It is not always easy to find another qualified rep in a short period of time, especially if the product or service is specific. The current rep is difficult to be replaced because any replacement rep must take times to learn the product or service information again.

This leads to a difficult negotiation where complicated safeguards have to be incorporated in the contract. In the end, it may be easier for the company to use internal resources rather than to go through a painful negotiation. If the company owns the human assets itself, the incentive to cheat disappears and the cost of creating safeguard contracts is eliminated. Thus, all other things equal, external sales rep can be expected to work on issues that have low human asset specificity. Although some people argue that possessing

confidential information sheds a light on opportunistic behavior, empirical research done by Anderson in 1988 shows that confidential information, need to know accounts, customer complexity and importance of key accounts do not have a statistically significant determinacy on governance structure. In fact, products and company nature are the major types of human asset specificity that lead to the choice of direct sales force.

Whenever a company's products displaying distinctive features and applications, salespersons must learn in order to serve a customer effectively. This knowledge a salesperson acquires about the selling products are highly asset specific to his/ her company (Anderson and Schmitlein 1984). When the salespeople have to learn the " company's peculiarities and forging working relations internally" (Anderson 1988), " the company the salesperson represents is idiosyncratic". The idiosyncratic nature leads to a high potential of opportunism. Since Williamson assumes that structuring the relationship within the firm can eliminate idiosyncratic knowledge and skills, we can expect that firm with the specific and non standard products and company nature may internalize the sales force.

B) Uncertainty: Performance Evaluation Difficulty and Environment

Unpredictability Williamson argues that transaction with high uncertainty will be more efficient if governed completely by internal structure. Uncertainty may be considered as performance evaluation difficulty and environment unpredictability. In terms of selling function, Anderson and Shmitleinn (1984) outlined three reasons for difficulty of evaluating performance. First, it is sometimes difficult to record each salesperson's performance accurately.

Taking air freight selling service as an example, salesperson works at customer level whereas records are kept at warehouse level.

Second, not every sale can be measured at an individual level. It is not always only one salesperson is responsible for a sale. Especially when team sales are involved, customers may find it more convenient to place order to any sales available at the time of placing order rather than insisting on finding the one who does the presentation. In that case, it is problematic in evaluating whether one salesperson performs better than the other one.

Third, the “ performance” may not be measured or observed by any indicator or scales. As a result of high uncertainty of performance evaluation, it is difficult and expensive to create contracts which cover all possible outcomes. The problems of evaluating sales performance and of suffering potential opportunism under high human asset specificity can contribute to a company’s decision on having unilateral control over the transaction by having the sales force in-house. However, environmental unpredictability alone will not lead to a decision on the use of in-house salesperson (Anderson 1985). Environmental unpredictability must go hand in hand with high degree of transaction specificity of assets in order to influence the firm decision on sales force internalization.

We should bear in mind that uncertainty only raises market transaction execution costs only if there is opportunism. In a market with high asset specificity, a firm cannot re-contract with other sales rep if changes in contract specification need to be made. If there is high uncertainty associated with a transaction, the firm cannot specify all the contingencies

that might impinge on contract execution and thus cannot defend against sales rep opportunism. Therefore, high degree of human asset specificity and uncertainty are joint conditions for a decision to make sales force in-house. C) High Transaction Frequency TCA holds that if the transactions are frequent there is once again a tendency to manage the transactions through bureaucracy since the repetitive contracting cost will be higher than the bureaucratic cost. In sales setting, successful selling of a single product or service may be counted as one transaction.

A firm's revenue ties closely with transaction frequency. The higher the transaction frequency, the higher the revenue it will have. Under normal economic situation, higher revenue may mean higher profit. Arguments for Outsource Sales Force Internalize sales force can minimize the opportunistic behavior thorough exercising authority. In contrast, outsource sales force seems to be vulnerable to opportunistic behavior because of performance evaluation difficulty.

Why do some firms still shift sales onto someone else's shoulders? The best part will be the zero cost or at virtually no fixed cost as reps work solely on commission. Product line synergy and customer loyalty to salesperson are added arguments. A) Product Line Synergy Reps typically handle a portfolio of related but non-competitive product lines, working under a contractual arrangement within a defined geographic territory, on an exclusive basis within their assigned field of responsibility. For example, reps may concurrently sell company A's lamp and company B's light bulb to one customer. Clearly, reps present broad-based solutions to customer problems, rather than the price-and-delivery responses typical to single-product selling.

Their consultative approach not only opens the door for other lines, but also adds value and stimulates a partnering relationship with the buyer, as the purchase progresses through an entire project.

Because of their multiple-line perspective, reps are more likely to look at the forest, not just the trees. The multiple-line sales professional can afford to call on customers too small to be profitable for a single line. B) Customer Loyalty to Salesperson Many “ rep” firms have worked in the same industry and territory for decades, providing instant access to customer relationships that could take years for a firm to build and cost hundreds of thousands of dollars. Independent rep may bring unique selling skills that can be leveraged, and offer the ability to create virtual company offers by bundling various products into a best solution. In fact, most successful reps have worked for decades with the same customers, who have come to rely on the reps as trusted advisers who help sort among an ever-expanding array of products and services. It is therefore easier for customer to develop loyalty towards the rep.

Under this situation where customers are loyal to the salesperson rather than to the company or the product, Anderson (1985) finds a greater likelihood of using rep. Reasons for using Independent Representative Apart from the above mentioned arguments, reasons underlying the choice of independent representative can be discussed in terms of TCA as: low degree of asset specificity, impact of production cost, and technology advancement on easing the performance evaluation difficulty. A) Low Degree of Asset Specificity Anderson (1984) claims that “ when assets are fungible, market contracting is preferable since the agent pooling several firms demands

more fully exhausts scale economies and risk-pooling benefits. ”

Furthermore, most of the independent reps are professional, multi-faceted, and knowledgeable. They typically possess all the necessary sales skills or even sometimes outperform the in-house sales agent. If specific product knowledge or company nature is not involved, the degree of human asset is said to be low.

Under such condition, independent rep is less likely to pose a threat of opportunism on principal firm as the switching cost to another rep is comparatively lower. Since reps often live with contracts with a 30-day termination clause, they are under the threat of ready replacement for opportunism behavior. B) Impact of Internal Transaction Cost Minimizing the sum of transaction and production costs in deciding vertical integration is the objective of TCA (Klein, Frazier, & Victor 1990). Although many studies on the choice of internalize or outsource sales force overlook the influence of internal transaction cost, we cannot discard its impact on vertical integration. Veni and Ravenscraft (1994) studies have shown that when the internal transaction costs are thoroughly analyzed, they can be extremely high.

Not taking internal transaction costs into account thus biases decision making process. In all calculations, management must include internal transaction costs as well as those associated with external sourcing. If the company is to produce the sales service internally on a long-term basis, it must back up its decision with continuing R, personnel development, and infrastructure investments that at least match those of the best external supplier; otherwise, it will lose its competitive edge over time. Moreover,

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going in-house can be recognized as a new business development which has potential to diffuse a company's focus from the way it typically generates its revenues.

It can simply imply an inflation of head count. This could well enhance the overhead instead of achieving profit maximization. In fact, managers often tend to overlook such backup costs. One of the great gains of outsourcing is the decrease in executive time spent on managing peripheral activities — freeing top management to focus more on the core of its business.

Therefore, reps who are not on the company payroll, and who don't get paid until they actually sell something, are now more than ever the choice of companies, particularly in Internet business setting. Joining an ad network is one of the best ways a small website can generate advertising revenues.

With no advertising sales staff, the best recourse for small online operations would be to outsource the process of selling its ad inventory. This is best accomplished by the ad networks, such as DoubleClick and 24/7 Media, which provide the sales force that sells space on member Websites to advertisers and media companies. It is perhaps the quickest way to increase the small website sales and extend the reach on the Internet all at the same time. It is just like having a sales force that can grow as big as you'd like, and you only pay them when and if they bring you a paying customer.

Doubtlessly, affiliate programs are powerful tools that can rapidly improve a website's online sales. Besides, another example may be telesales support.

In the early stages of a market, a firm may attempt to capture a large market share through volume expansion. Speed in sales service delivery

then becomes a strategic criterion for the firm in selecting its structure of sales force. Telesales is one option. It is also an area a firm can successfully delegate to outside professionals who provide competence not available internally.

If a firm doesn't already have the financial support and expertise on board to run an efficient, productive, telemarketing operation, outsource should well be the decision of choice. The savings and efficiency of doing it right first time – versus stop/start learning from mistake after mistake, from crisis after crisis – are overwhelmingly in favor of outsourcing. However, we should bear in mind that some aspiring telesales providers have failed to realize that their businesses will hit a wall, for eventually individual customers are likely to bring the streamlined activity back in-house and to manage it just as effectively as a specialist could if they do not extend their innovations to a number of customers. Only economies of scale provided by a large client base and the economies of skill developed by confronting a variety of situations can enable specialists to maintain their advantage over their customers. C) Technology Advancement Streamlines Sales Process and Performance Evaluation Balakrishnan and Wernerfelt (1986) suggest that a far-sighted firm will base its vertical integration decision on the anticipated changes in technological conditions, rather than solely on current conditions.

The Yankee Group forecasts on web-based customer relationship market reaching \$530 million in 2001 may well be an indication that eCRM (electronic customer relationship management) will have an expanded role in support of sales management by providing enhanced tracking, reporting, and sales performance monitoring (Georgia 2000). The Internet and CRM will

also drive instant access to more detailed customer information and prospect profiles, such as inventory status, order status, customer history, earlier in the buying cycle. Armed with this tool, the firm can better monitor the sales process handled by sales rep as effective sharing of information between firms and reps become possible. In return, sales manager may have a better monitor and evaluation for the sales rep performance. According to TCA, a firm may favor forward integration under less uncertainty environment.

Intuitively, the reduction of business processes to digital form brings the company and its providers closer together, further reducing transaction costs. Firms will therefore favor using reps in condition of low asset specificity if technology enhancement tools (e. g. eCRM) can minimize uncertainty and opportunism, Conclusion Using TCA as a framework, the paper shows that the choice for sales service turning to internal or external hinges on the degree of asset specificity, uncertainty, and frequency of transactions involved. The more specific an asset, the greater its uncertainty will be, and the higher the frequency of the transaction, the greater its cost will be in relation to a market contract, also that the transaction will move to a more internal organizational form (internal sales). If these factors are low, then buying the services in external market will be a better solution.

This explanation is supported by Anderson's empirical findings on electronic component industry. Nevertheless, Geroge & Barton's (1988) criticize on Anderson's study for the conscious exclusion of territories operated simultaneously by internal sales force and independent reps seems to imply that TCA simply predicts a "make or buy" decision but ignores a "make and
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buy” decision. It is therefore noteworthy that TCA appears silent on the issue of predicting the possibility of having two governance forms for the same function (e. g. sales function) within same firm.

While TCA provides a framework on explaining the decision of integration of sales force, I think how much control the firm wants may sometimes be a better explanation than how much control the firm needs on discussing why some firms choose internal sales force especially when TCA predicts external sales force is optimal. From psychology point of view, the sales manager who believes that the sales force needs to be led every step of the way creates a self-fulfilling prophecy. Oliver Williamson’s managerial utility maximizing model also helps to explain that situation. The model assumes that managers attempt to maximize their own utility (Davies and Lam 2001). Using some potential profits to recruit large number of salespersons is unnecessary spending that leads to sales manager’s power, prestige and status satisfaction.

Furthermore, many companies unfortunately assume that because they have historically performed sales activity internally, or because it seems integral to their business, the sales activity should then be internalized though the marketplace transaction would be more favorable. Recently, laid off is hot topic on local newspaper. Apple Daily (20 Nov 2001) reports that HKSAR government records a statistic of about 300 people become jobless daily. Facing economic downturn and competitive business climate, any company, regardless of size, will maintain streamlined operations and maximize their sales potential. Recruiting manufacturers’ representatives may seem to be one of the practical approaches to downsizing. I guess more and more

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companies will turn to outsourcing as a value-added solution to augment existing expertise, reduce fixed costs, improve efficiency, increase responsiveness and improve quality.

Although there are always some inherent risks in outsourcing, there are also risks and costs associated with internal integration. With a second thought on internal transaction cost and technology advancement, companies may choose to outsource sales force to overcome many of the costs and risks. Outsourcing of all or part of the sales function will become more viable for start-up and emerging companies with limited or no sales departments as well as for larger organizations with lean staffs in order to soothe the major financial burden on building, training, and maintaining their own niche market sales forces. In fact, the trend is visible today in mega-billion dollar worldwide companies like 3M and Microsoft. It is hard to imagine Microsoft top managers taking their enthusiasm and skills in software into, say, sales service training and development. And if they did, what would be the cost of their loss of attention on software development? References Anderson Erin (1984).

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