What are transaction costs and essay

Business, Marketing

Why are they Important?

What are transaction costs and why are they important?

The term Transaction Cost was first introduced by Ronald Coase in 1937, who defined it as " the cost of using the price mechanism'. In simple terms, in order to interact or transact in a given market, one must know who are the people or organizations that one will be interacting with, to communicate to people in the market that one is ready to make a deal and terms on which the deal is expected to be made, indulge in bargaining and negotiating of the deal, to draft the agreed terms in the form of a contract, to evaluate and monitor whether the terms of the contract are being followed and implemented by the parties involved and other such regular transactional decisions that need to be made. Transaction costs are the expenses incurred when fulfilling these tasks, or the cost of identifying trade partners and the implementation of transactions .

Although the definition given by Coase appears to be simple enough, its implications and comprehension among economic scholars has been varied through the years. To begin with, scholars have remained divided on the focus area of transaction costs. While the most basic method of measuring transaction cost has been to note the difference between buying and selling prices. On the other hand, according to the Williamsonian of transaction cost, the focus is laid on secondary costs, mainly the cost of negotiating or bargaining the deal and implementation of the contract . Another view emphasizes the influence of government laws and regulations that create barriers to market entry and the conducting of transactions which leads to a reduction in market size or the complete elimination of it .

Considering the various approaches that scholars have taken, transaction costs can be classified under three kinds: a) the cost of search and information – is the required product or service available in the market? Who is selling it? Who is offering it at the lowest price?, b) cost of negotiation – in terms of an asset trading market, this could be the ' bid and ask' transaction, in addition to the usual agreement of terms and drawing of contracts, and c) implementation costs – ensuring that the seller is adhering to the terms of contract and the costs associated with action taken in case the agreement is not honoured .

The measuring of transactional costs is crucial as they represent a cost that was traditionally not taken into considering when calculation cost of production or operation, thereby leading to incorrect accounting of profits. Before Coase put forth the concept of transaction costs, it was assumed that transactions themselves cost nothing and hence transaction cost would be zero. However, today we know that every transaction undertaken has a host of costs involved and, the larger the scale of an organization's operations, the greater the bearing this cost will have on overall profitability. For example, every time a person uses a credit card at a department or grocery store, a fixed percentage is charged to the vendor. If this cost, a transaction cost, remains unconsidered, it could reduce the profit margin of products sold by over 5%. Similarly, the cost of taking legal action against vendors who break contracts or even the cost associated with communication while negotiating has an impact on profits. As such, the measuring of transaction costs is crucial.

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