1. Introduction

This chapter gives a first impression of the increasing importance of managing transaction costs in the era of globalization. It defines the skill of keeping transaction costs low as transaction cost management, or shortly, transaction management, and explains its role in transaction economies. By keeping the costs of trade transactions as low as possible, the value creation from these transactions is optimized. Here, trade transactions are defined in the broadest sense, including all kind of transactions which specialization and the resulting need for coordination bring about. This chapter also contains a reading guide for the book.

1.1 GLOBALIZATION AND THE ORGANIZATION OF PRODUCTION

In this era of globalization and computerization, the division of labour and specialization in production and services are the main sources of economic prosperity. Specialization uses economics of scale and the skills and tools of others to reduce total production costs and/or to improve the quality of products and services. This was already true in 1776 when Adam Smith wrote about the gains from specialization in *The Wealth of Nations*. It is much truer in these modern times where production chains are split up further and further so that there is more and more fragmentation of production. In contrast to producers who make all the parts and components of the product themselves, specialization in the manufacturing and service of parts and components has become standard. Nowadays, there are numerous examples of hiring staff and the outsourcing of tasks, especially outside the core business of the organization (such as catering or maintenance in an office building or the outsourcing of administrative work). Trade in products in the traditional sense, driven by the Ricardian principles of comparative advantages, has now gradually been transformed to a trade in tasks.

These developments, which the globalization and new possibilities of information and communication technology (ICT) have brought about, also deeply change the way production of goods and services is organized.
Instead of executing all tasks themselves, the producers of a final product or service have now become the orchestrators who successfully connect the individual parts of the production chain to each other. The focus now has come to lie in the orchestrating function, which aims to fully exploit all the advantages of this specialization and the fragmentation of production. That is why modern economies, where economic activity is more and more directed towards this orchestrating function, can be characterized as transaction economies. Hence, a transaction economy is focused on the organization of production and can, therefore, also be labelled as an orchestration economy. This transition from production to orchestration is also reflected in the statistics of such economies: agricultural and industrial production are losing their shares of the domestic product in favour of services.

The scope of the trade transactions, which this new way of organizing production brings about, can be very broad. The transactions may take place within the organization (for example, between offices or business units) or outside the organization (outsourcing, procurement, supply chain management (SCM)). They may take place at home or abroad. They may take place only once, be recurrent or take place very frequently.

With respect to all these different types of transactions, the orchestrator seeks to exploit the advantages of specialization (higher quality and/or lower production costs) as much as possible by keeping transaction costs as low as possible. Of course, these transactions differ from case to case. Cost saving can relate to the preparation of a transaction or to implementation and enforcement. The costs are often difficult to trace in an organization, because it is sometimes rather fussy to register which workers are involved in preparing, implementing or monitoring transactions, and which are involved in the pure production process. Think of a farmer: when he is feeding his animals, cleaning the stable or collecting his crop, he is engaged in production, but when he takes his cow or crop to the market or is doing his accounting to adhere with government regulation, he is involved in managing transaction costs.

Being successful in orchestration, and thereby being good at managing transaction costs, requires (superior) knowledge of markets, products, production technologies and supply industries and services. It also requires strategies to cash in on the created added value. In addition, ICT and advice from professionals such as lawyers, management consultants and tax experts can be important to controlling transaction costs. All this is very knowledge-intensive and can, in one way or another, be supported by innovation policy.

This book takes this management of transaction costs as a guiding principle. Apart from comparative advantages in production, transaction
costs are the main determinant of (international) trade flows. Similarly, differences in transaction costs are crucial for the location and investment decisions of firms on where to produce and on where to organize and orchestrate production in their headquarters. Therefore, knowledge on transaction costs, and on how to manage transactions, is vital for these trade and investment decisions.

This book labels the skill of managing transaction costs in an efficient way as transaction cost management, or more briefly as transaction management. It must be admitted that this label of transaction management is used in a much broader sense than in the accustomed case where advisors in transaction management are mainly concerned with monetary and contractual matters in conducting transactions. Within the broad scope of managing transaction costs, efficient transaction management that reduces transaction costs will make existing trade more profitable and will lead to more trade. It strengthens the competitive position of individual firms and, through spillover effects, of the whole nation, so that it enhances welfare. In this way, a reduction of transaction costs creates value for firms and society. The conundrum is that with lower transaction costs total transactions will rise more than proportionally so that transaction costs will take a larger share of total costs. This enhances the importance and profitability of transaction management. Hence, briefly stated, transaction management is the ability to keep the costs of trade transactions as low as possible so that the value creation from these transactions is optimized.

The more knowledge there is on these aspects, which is partly tacit knowledge, the better the management of transactions can be strengthened. In the world of globalization and global (out)sourcing, it is vital for firms to preserve the orchestrating function in the production, demand and supply networks. Major questions in this respect are: where and how can we buy ideas for new products and services; how do we obtain knowledge on making these products and providing these services; where do we find labour; and where and how can we continue and improve selling these products and services at the highest margins? Financing and risk management are an important part of that management function. It is this new role for professional businesspeople that is a key component to transaction cost management. Therefore, another major focus of how to manage transaction costs is to cope with cultural diversity. The ability to work with different cultures is a vital skill for a good trader. Transaction management is about all these aspects of a modern knowledge economy. That is why this book considers transaction management as a main road to value creation in this era of globalization.

From the theoretical perspective this book looks at transaction management from the viewpoint of transaction cost economics and new
Managing transaction costs in the era of globalization

in institutional economics. These theories are concerned with the organization of production and with the governance of the firm. The question is what governance structure – via the market, hierarchy or some hybrid form in between – brings about the lowest transaction costs in production. From this perspective, transaction management is about selecting the best governance structure for value creation. The skill of selecting the optimal governance structure is not only relevant for a firm being competitive but also for the welfare of a nation.

All in all, it implies that managing transaction costs efficiently is a key competency in the globalizing world of today and tomorrow. The purpose of this book is to investigate and elaborate this argument, and make it operational for practical purposes. The upshot is that efficient transaction management, and finding new ways to reduce transaction costs, will enhance the profits from the fragmentation of production and global outsourcing of tasks. It will bring about an increase in the productivity and competitive position of orchestrating firms and nations. Eventually it will add to consumer welfare, not only through lower product prices and quality improvements, but also through enhanced diversification of products. The latter aspect brings an important addition to consumer surplus. Moreover, tailored production also emphasises the importance of good transaction management as more diversity makes control over transaction costs even more significant for competing firms. For those reasons, the book also discusses the mutual relationship between transaction management and knowledge and innovation policy. As this book is explicitly based on modern theories of transaction cost economics and new institutional economics, and provides examples for applying these theories in practice, transaction management should not be regarded as another heuristic management tool.

1.2 CONTENTS OF THE BOOK

The contents of the remainder of the book are as follows. The underlying argument of transaction management is that much of the wealth in the world comes from specialization and the division of labour. That is what makes modern fragmentation of production pay off, and that is why the focus of value creation lies more and more in the efficiency of coordination (Chapter 2).

This fragmentation of production and value creation through efficient coordination characterizes the position of what this book calls transaction or orchestrating economies. It also plays a pivotal role in the relationship between the new, emerging economies (Brazil, Russia, India and China, usually termed BRIC countries) and the European economies. From that
Introduction

perspective it is useful to obtain a quantitative impression of the position of a number of transaction economies as a ‘hub’ in world trade using data on trade flows (Chapter 3).

The globalizing world of more and more specialization and an extended division of labour brings about more transactions. Therefore, transaction costs play a crucial and ever-increasing role. The economic theory of transaction costs teaches us about which types of transaction costs are involved and how these transaction costs affect the working of the economy. It is this theory of transaction cost economics, and more generally the links between this theory, modern trade theory, new institutional economics and economic theory of the organization of production, which provide the key scientific underpinnings of transaction management. It appears that transaction management can and will be applied to a much broader range of ‘transactions’ than one is initially inclined to think (Chapter 4).

Thanks to the reduction of transaction costs, more parts of the production chain can be outsourced to suppliers, subcontractors or specialized plants of firms. Sometimes outsourcing is in the home country, but more often it is abroad. This implies that outsourcing and offshoring are becoming important strategic decision tools in the transaction management of businesses. As mentioned before, this transforms internationally-operating firms in the home country from a manufacturing-oriented industry to one based on orchestration and transaction management. This transition is very much what can be observed in reality in the globalizing world. Characteristic of this is to let others perform various tasks in the production chain, both within a developed economy but more so in major emerging economies (including the BRIC countries) where, for the time being, wages are low. In Chapter 5, some examples are given of this increasing emphasis on the orchestrating function.

Computerization and globalization seem to be important determinants of trade flows. The empirical analyses of trade flows use so-called gravity equations, which include various determinants for transaction costs. Trust is one of these determinants and another one is the extent to which specialized knowledge is needed to execute outsourced tasks. This trade in tasks is illustrated with data on trade between the Netherlands and China (Chapter 6).

An important but perhaps somewhat undervalued part of transaction management is standardization. Standards that reduce transaction costs come in many forms. It is likely that still much efficiency is to be gained from further standardization, for example in the handling of the trade of European assets. By contrast, established standards carry the danger of being inflexible and underutilizing new technological opportunities. Another aspect linking standardization to transaction management is that consumers are more and more interested in diversity of goods and of
services by asking for tailored products. It makes standardization more complex and it influences transaction costs (Chapter 7).

This illustrates the link that exists between transaction management and innovation. Innovation does not only relate to new technologies that enhance productivity by the design of new products or by a more efficient technical production process: innovation can also contribute to the increased efficiency of conducting transactions. When innovation is targeted towards reducing transaction costs and thereby on value creation through better transaction management, it will contribute much to increasing competitiveness in transaction economies. In particular this means open forms of innovation that contribute to value creation through the better organization of production. This illustrates how the transaction economy and the knowledge economy are two sides of the same coin. Because transaction management is internationally-oriented in the globalizing world, excellent skills on how to cope with cultural diversity are key components to this discipline (Chapter 8).

Innovations in transaction management are not only valuable for firms that implement them, but also other firms, and more generally society as a whole, can benefit. This means that these transaction innovations – or trade innovations – bring about so-called positive externalities. The theory of public sector economics points out that the role of government is to exploit these externalities: in linking innovation policy to trade policy, the government should facilitate and stimulate knowledge investments, which in turn enhance the efficiency of conducting transactions. It should also avoid negative externalities playing a role. A major question in this respect is whether the government should conduct an active industrial and innovation policy by ‘picking winners’ – that is, by selecting key economic sectors that will obtain government support to enhance their competitive positions. This targeted policy has its pros and cons (Chapter 9).

However, transaction costs are also important in the implementation of government policy. Here, implementation costs are made up both by the government itself and by the citizens and businesses who are subject to government policy, which in most cases will relate to some kind of government regulation. Various institutional arrangements, which facilitate discussions and finding compromise agreements between stakeholders with different and sometimes conflicting interests, and a good use of modern technology, can help make the implementation of government policy efficient and avoid unnecessary transaction costs (Chapter 10).

Finally Chapter 11 summarizes in a number of key statements the significance and meaning of an efficient management of transaction costs. It describes the steps to be taken in the practical application of transaction management.
1.3 ORIGIN AND BACKGROUND OF THE BOOK

This book originates from a research programme which was a follow-up to a policy advice to the Dutch government by the Scientific Council for Government Policy (WRR, 2003). Therefore, there are ample examples and case studies relating to the Netherlands. Yet, the general philosophy of transaction management is applicable to firms and government policies in all modern welfare states with open economies.

As a trading nation, the Netherlands has certainly, since the Golden Age or even before (think of the Hanseatic League), been good at keeping the costs of transactions low – that is, good at transaction management. The painting ‘The Syndics’ (Staalmesters) by Rembrandt (Figure 1.1) symbolizes that, as early as the seventeenth century Dutch traders realized the importance of keeping transaction costs low. The syndics controlled and categorized the quality of ‘laken’, a fine woollen fabricate, so that it was unnecessary for traders to control for quality before every transaction. By trusting the hallmark of the syndic, buyers and sellers of this fabricate

Source: Reprinted with permission of Rijksmuseum Amsterdam.

Figure 1.1 The painting ‘The Syndics’ (Staalmesters) by Rembrandt symbolizes good management of transaction costs in the seventeenth century
Managing transaction costs in the era of globalization

did not incur high costs in each transaction because they had come to an agreement on the quality of the ‘laken’. Moreover, traders could rely on realized prices for standards of various qualities. This shows how important it is for traders to be able to rely on standards, which are preferably uniform and valid throughout the world. This facilitates transactions and promotes trade (Chapter 7). Moreover, the quality standards set by the syndics were trusted because they were a forerunner to the famous Dutch polder model of consultation. All members of the standard-setting committee came from different religious backgrounds. A painting, made by a well-known painter and that shows distinguished gentlemen, can help establish trust, which is a major device in transaction management. These aspects of trust and keeping transaction costs low by good consultation and organization of discussion between various interest groups are of major importance both for implementation of strategic plans and joint ventures in the business sector and for finding societal support for policy plans by the government (Chapter 10).

The hypothesis of the WRR report is that as a trading nation the Netherlands has a comparative advantage in keeping transaction costs low. This book poses the same hypothesis for similar transaction economies. These comparative advantages can be exploited further in the future through good transaction management. It will enhance the competitive position of these transaction economies. However, it is difficult to test and support this hypothesis in a direct way scientifically. For such an analysis comparative data on transaction costs and value creation through a reduction of transaction costs should be available on a time series basis for several relevant competitor countries of the transaction economies. Yet, one could argue that a mercantilist and commercial tradition of these nations may constitute a guarantee for obtaining and maintaining these comparative advantages. This commercialism, or to formulate it differently, being a good tradesman, is a skill that is not entirely based on good education and that cannot be obtained by studying books. It is a form of entrepreneurship, which is partly innate and must partly be learned in practice by trial and error (see Box 1.1). The story in this box, published in 1999, provided the inspiration to start this book on transaction management (Den Butter, 1999).

Given the origin and scope of this book, it is inevitable to look back at the glorious past of the Netherlands as a trading nation in the assessment of present and future transaction management. In fact, the United East India Company was the first internationally-operating modern enterprise where the importance of transaction management was recognized, although without naming it as such. Today the good parts of the United East India Company mentality are to be cherished, but the bad parts
Economists have the most ingenious theories to explain economic phenomena. However, when it becomes important to understand practice, learned economists remain silent and ignorant. Take entrepreneurship for example. There is a need for good businesspeople, or entrepreneurs, who dare to take risks and who intuitively know the right business strategy to choose. They are good for the country because a climate where new businesses flourish brings much profit, employment and welfare. Economic theory has, however, only shaped a colourless, representative rational entrepreneur. He or she will, given the available information, always make the best decisions, but has, furthermore, just a random chance of bad or good luck. The unlucky entrepreneur goes bankrupt, whereas the lucky one makes huge profits. There is no place in the theory for intuition or for the enforcement of good luck.

According to the theory, investments in knowledge make firms profitable. These investments comprise both investments in research and technological development, which may result in new products or making production more efficient, and investments in human capital. In the latter case, knowledge is acquired through education, but also through work experience. These investments in knowledge are again based on rational considerations: the proceeds from using the acquired knowledge has to make investments profitable. This rational theory of knowledge investments, therefore, has little to do with intuition and ‘Fingerspitzen Gefühl’, which distinguishes the good entrepreneur from the bad. One does not become a good entrepreneur or a good trader – which is more relevant in trading nations – by means of sheer rational calculations. Such skill is culturally determined, almost innate, and anyhow obtained by playful learning, preferably when one is young and in the streets, just like the top football players.

The craze of collecting Flippos has been over now for some time. The successful Flippo campaign was launched by Smiths Chips, a firm selling potato chips, in the spring of 1995. Flippos are small round plastic disks with Warner Bros cartoons on them that are put in the bags of chips. Collecting and exchanging Flippos became popular among children, teenagers and young adults.
The commotion of my sons with Flippos made me realize that this kind of epidemic collecting and exchanging among youngsters can contribute to the formation of what we may label the entrepreneurial spirit of a tradesman. It reminded me of a collecting craze from my own primary schooldays. In this case, the items to collect were cards with cartoon drawings of football players. For each country, there was a quartet of cards with the four most known internationals of those days. Therefore, the aim was to collect the full game of quartet cards of international football. It was only a small inconvenience that, to obtain cards, you had to buy pieces of awful-tasting pink chewing gum.

Therefore, a lively barter trade in these football cards developed among my schoolmates. By coincidence, or perhaps the cleverness of the chewing gum marketer, not all players were equally available. Therefore, for some players you soon had a duplicate, while other players were very scarce. It resulted in a lively market mechanism with the formation of relative barter prices. For example, the value of the Dutch player Van der Hart was three times that of the Austrian player Happel (it had nothing to do with the true skills of the players). This process of price formation was complicated by the fact that you had an extra interest to get a full quartet. Therefore, you were willing to pay a relatively high price for a player who completed the quartet. Moreover, it was more difficult to obtain a complete quartet for one country than for another. The result was that, in this barter trade, a network of information developed about who had specific cards for exchange, and about which were the current exchange conditions. I remember that the last quartet that I had to complete was Brazil, as one player, Garrincha, was very scarce. Of course I told my friends that I wanted that card desperately and that I was ready to exchange that card for many other cards – even for a full quartet of another country. Eventually, this information had become so far spread that one of my friends brought me into contact with a boy from another school who was interested in the exchange. I forget whether I had to give this friend a commission in the form of some pink chewing gum, or even a number of football players.

At the risk of repeating that everything was better in the olden days, the collecting craze with Flippos unfortunately contributed less to developing the entrepreneurial spirit of the trader. My sons made me understand that in the case of Flippos, trade was
confined to a simple barter of double Flippos. Yet, in the Flippo craze, a game element was introduced, where, by taking risks, Flippos could be won or lost. However, this element of a game in the Flippo entrepreneurship only mimicked the standard economic theory of random chances where entrepreneurs with good luck make profits but those with bad luck may lose all of their Flippos. In the Flippo craze, there was no reward for intuition or for the good interpretation of price signals and other information. The only other mirror of the real world in the Flippo game was that the biggest risk-takers ended up with a large gambling debt and stole Flippos to pay off the debt. That can hardly be regarded as a positive contribution of the Flippo craze to the formation of a sound commercial spirit. However, maybe I paid too high a price for Garrincha in my schooldays as well.

should be avoided. The Chinese witnessed these good and bad parts as early as the seventeenth century:

The Hollanders are greedy and cunning, have a lot of valuable knowledge and were clever in the pursuit of advantage, for profits they even risk their lives and there are no places where they do not dare to go. . . . These people are also very capable and resourceful, they make sails as spider webs, which they can turn to all sides to catch the wind, so they manage to sail with the wind in every direction. (Zandvliet and Blussé, 2002, pp. 19–20)

Overconfidence and greed have no place in modern times. However, the tradition of a trading nation using technical knowledge and product knowledge for profitable trade still has a place. Discovering and exploiting all new opportunities at a global scale is a key ambition in the transaction economy. That is the essence of transaction management as a key competency for a modern open economy where trade transactions are drivers of economic welfare.