Transaction Cost Economics As a Constructive Stakeholder Theory

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We submit that the central managerial messages of transaction cost economics (TCE) have been lost or misconstrued in academic debates that miss the underpinning logic of the theory. Critiques of TCE are often based on narrow and selective interpretations, indeed caricatures. Our goal is to set the record straight by examining TCE’s fundamentally constructive aims, logic, and its applicability in the classroom. Looks can be deceiving: While TCE candidly acknowledges that bad things sometimes happen, the main message is not only constructive and positive, but also consistent with a stakeholder theory of management. Indeed, we maintain that TCE can be applied as a constructive stakeholder theory.

Transaction cost economics (TCE) presents an interesting puzzle to management scholars. On the one hand, building on Coase (1937), its main architect, Oliver Williamson (1975, 1985, 1996b) received a Nobel Memorial Prize in Economic Sciences in 2009. The 3-minute introduction of Williamson’s works at the Nobel Prize award ceremony by the chairman of the Economic Sciences Prize Committee, Professor Bertil Holmlund, offers unequivocal praise of the groundbreaking merits of TCE. On the other hand, while some of the early academic reviews of Williamson’s work were positive (e.g., Ouchi, 1977), several notable authors in management have voiced fundamental reservations and leveled forceful critiques of TCE. One prominent strategy scholar, Sumantra Ghoshal, suggested that “bad management theories are destroying good management practices” (Ghoshal, 2005: 75), directly implicating TCE and agency theory as the main culprits (see also Ghoshal & Moran, 1996). TCE has also been criticized for starting at premises that are expressly negative; we need theories that are “expressed in positive terms” (Nahapiet & Ghoshal, 1998: 256). Other management theorists, such as Jeffrey Pfeffer, not only voiced this sentiment, but went on to argue that the state of the management education field is even worse: Economics training in business schools “can have deleterious effects” as “economics training also has some important consequences for behavior” (Pfeffer, 2005: 97). Critiques of TCE are not just a matter of one or two dissenting voices; the list of influential management scholars who have either directly or indirectly implied that TCE is a bad theory for organizations is extensive. What is going on here?

The question seems fitting not only because this discrepancy is puzzling, but also because “What is going on here?” is the main question Williamson (e.g., 1996b: 25, 2010: 217) has asked throughout his career. In the spirit of his contemporary scholars working to understand managerial behavior, Williamson’s goal has been to develop an understanding of complex economic problems. In particular, TCE is concerned with understanding economic exchange (i.e., transactions) in situations where transactions are complex and a lot is at stake. Contracts are unavoidably incomplete because transactions are complex, or it is too costly to specify the course of action under all possible contingencies. A source of complexity is the fact that transactions

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occur not in isolation, but also within a broader system of organizations and institutions. In this sense in particular, TCE differs from much of modern microeconomic thinking; this is also why TCE is highly relevant to organizational scholars. Last, rationality may be severely constrained: Parties to a contract are privy to very different kinds of information, the future typically cannot be predicted to any appreciable degree, and only a naïve decision maker relies on the assumption that the contracting parties will see eye to eye in the event of all unforeseeable conflicts. What TCE tries to help us understand is how individuals and groups make (and should make) decisions in a way that generates economically efficient outcomes.¹ But to achieve this goal calls for understanding complex contracting in its entirety (Williamson, 1985: 35), in which contracting parties have the foresight to create safeguards to maintain the integrity of the exchange relationship. We see this view as a fundamentally constructive premise for theorizing and research.

In contrast to some accounts in the management literature, we maintain that the key messages embedded in TCE are squarely constructive. Unfortunately, these insights have gotten lost in the interdisciplinary turf battles and misattributions that surround economic theories of organization in particular (Ghoshal, 2005; Pfeffer, 2005). We want to set these turf battles aside here. But we accept Ghoshal’s (2005) general challenge: We embrace the idea that business schools and academics must critically re-evaluate their roles and not assume the role of a bystander when unfortunate events, such as corporate malfeasance, are encountered. We must make our voices heard in contemporary discussions and debates, an attitude exemplified by both Academy of Management Learning & Education and Academy of Management Perspectives. An example is Kaplan (2008) and Walsh’s (2008) exchange of ideas on executive compensation. Agreement is overrated; let us instead openly debate the key issues to advance our understanding. To this end, we need scholars trained in various disciplines—including economics—participating in these conversations. We further agree that as educators, we can have an effect on our students’ ethics and that ethical management can be both taught and learned (e.g., Gioia, 2002). But we fundamentally disagree with Ghoshal’s (2005) position that “bad theories” in general or TCE in particular are to blame. We also disagree with the implicit notion that we would be somehow better off without TCE in our classrooms. We argue just the opposite: We would be much better off developing a genuine understanding of TCE in our business school students.

UNDERSTANDING COMPLEXITY

In our research and in the classroom, we address complex problems. To tackle them with appreciable rigor, our theories and frameworks need to capture this complexity. At the same time, they must achieve this parsimoniously. Because of the requirement for parsimony, our theories can never match the complexity of the authentic organization. IBM is a massive, complex matrix organization with over 375,000 employees—how could our understanding of its structure and functioning be based on anything but simplifications? Simplifications often take the form of analogies and metaphors (Morgan, 2006). We write of the firm as if it were a nexus of contracts, a system, or a social structure, just to mention a few examples of the diversity, richness, and imaginativeness of our analogies. Our understanding of the organization is essentially metaphorical at its foundation. This is a two-edged sword. On the one hand, a metaphor can help us engage in conversation on the complex issue, and skillful use of analogies can lead to understanding, effective problem solving, and useful sense making. On the other, a downside is that the use of analogies often leads to fallacious reasoning, misattribution, and distortion.

Distorted analogy is unfortunately how some management scholars have come to understand TCE. In the most-cited critique of TCE in a management journal, Ghoshal and Moran (1996: 13) start with a fictional story of two hikers in distress:

[Two hikers wake up] one night to find a tiger lurking near their tent. One of the hikers immediately reaches for his running shoes. On being reminded by his partner that he could not possibly outrun the tiger, he responds that all he has to do is to outrun the partner. At a superficial level, the somewhat macabre humor of the situation also serves as a powerful reminder of the similarities between biological and economic competition. Survival of the

¹Williamson (1999a) suggests that while transaction cost efficiency is not the only consideration, a general efficiency examination is relevant in just about any context of economic activity, and for all organizational modes of governance (markets, firms, hybrids, government regulation). As an extreme example, consider the privatization of prisons: We think it is crucial to acknowledge that in private prisons, high-powered incentives (Williamson, 1985) are inappropriate, because they can lead to undesirable consequences, such as quality shading (Hart, Shleifer, & Vishny, 1997; Kivleniece & Quelin, 2012).
fittest, and, hence, the need to be the fittest, is seen as the moral of the tale.

Ghoshal and Moran (1996: 13) then argue that TCE “is based on a very similar set of assumptions.” This claim is not only incorrect, but the analogy is also a fundamental distortion of TCE. Williamson (1996a) pointed this out in his detailed response to the critique, but unfortunately, many management scholars do not seem to be aware such a response even exists.

Reconstructing the hiker story in a way that makes it a proper analogy may prove useful. Had the hikers taken the lessons of TCE to heart, they would never find themselves facing a tiger with running shoes as the primary safeguard. To clarify why this is the case, we start at the premise that TCE pertains to economic exchanges where the transacting partners are bilaterally dependent (Williamson, 1985: 91). Think of an automobile supplier that builds a subassembly plant next to its customer’s assembly plant in order to supply expensive make-and-model-specific subassemblies to final assembly. It would be very costly for the final assembler to find an alternative supplier, or for the supplier to find an alternative customer, should the exchange relationship terminate. Due to this bilateral dependence, dissolution of the partnership—analogously, one hiker running away from the other—is the very thing TCE seeks to prevent.

In TCE, what is the tiger? Presumably, if the two hikers are two actors engaging in an economic transaction, then the tiger is some unforeseen event that their contract did not cover. One hiker running away from the other is then equivalent to “holding up” the other hiker. But this outcome—indeed dubbed the holdup problem (Goldberg, 1976; Klein, Crawford, & Alchian, 1978)—is not what TCE condemns but tries to prevent. Contrary to common misconceptions, TCE does not pit the transacting parties against one another, let alone encourage one party “to get them before they get you.” The opposite is true: So much at stake that one hiker cannot entertain the option to outrun his companion. The safety measures TCE promotes are “reciprocal acts designed to safeguard a relationship” (Williamson, 1983: 519, italics added). TCE is primarily concerned with the survival of the exchange relationship, not the parties to the exchange, and certainly not just one of the parties. Packing running shoes as the primary safeguard is a unilateral act designed to safeguard only one party. If we want to construct the correct analogy, we need to replace running shoes with something that protects both; say, an all-terrain vehicle for use by multiple passengers to avoid harm (Williamson, 1996a).

The Achilles heel of analogical reasoning is that if it fails in any single relevant aspect, the entire analogy collapses. In this sense, analogies do not have the property of being “sort of right”—they either work or they do not. Insofar as the goal is to understand TCE, the hiker analogy simply does not work. But this is hardly an exception, as examples are numerous. For example, if one wishes to understand why thinking of a country as analogous to a very large diversified firm is a misleading premise for policy, one needs to understand the relevant ways in which a country specifically is not a company (Krugman, 1996). One dissimilarity can trump a dozen similarities.

We invite the reader to set aside potentially misleading analogies and try to understand TCE in the context in which it is meant to be applied. We find it useful to focus on Williamson’s (1996b) key question “What is going on here?” An example from Williamson’s early career is illustrative, because it not only asks this very question, but clearly had a major impact on Williamson’s thinking, serving as a central motivation to the development of TCE (Shapiro, 2010). The example also illustrates that TCE is indeed concerned with both explaining and prescribing decisions in a fundamentally positive, balanced, and constructive manner.

The U.S. Supreme Court vs. Williamson: The Schwinn Case

In the late 1960s, Williamson worked as Special Economic Assistant to the Assistant Attorney General for Antitrust at the U.S. Department of Justice. The U.S. Supreme Court had ruled that the bicycle manufacturer Schwinn’s franchising policies violated antitrust laws. Schwinn had, among other actions, restricted the sale of its bicycles to certain distributors. The Supreme Court ruled that such vertical restrictions were in violation of the Sherman Act (United States v. Arnold, Schwinn & Co., 388 U.S. 365, 1967).

Williamson was troubled by the Supreme Court’s decision and has in retrospect openly called it “deeply confused” (2002: 9). Williamson was critical of attributing vertical integration to attempts at gaining a monopoly position. To Williamson (2002), this view seemed to be the default attitude of the courts. Why did the Supreme Court not conduct a balanced inquiry and consider other plausible
accounts? In light of Williamson’s position regarding the Schwinn case, the fact that his formulation of TCE is often interpreted as adopting an overly pessimistic view of human agency (because of opportunism) is downright ironic: It was not Williamson but the Supreme Court that wanted to ascribe opportunism to Schwinn’s actions. Williamson, in turn, emphasized the importance of balance, and accordingly, wanted to give Schwinn executives the benefit of the doubt instead of readily assuming that they were up to no good. Indeed, vertical integration could also spell efficiency, and considering that transacting can be costly, “getting the transaction governance right” could lead to positive net gains to the franchisor, distributors, and customers of Schwinn bicycles (Williamson, 1985: 183–189). Note that TCE is primarily interested in the comparatively efficient way of arranging economic exchange: essentially how to avoid waste of effort and resources. In the case of Schwinn, Williamson was primarily interested in cost and quality: Without vertical contractual restrictions that ensure a set of sales and service attributes, the Schwinn quality image may be debased by free-riding and quality shading that harm quality reputation. The hypothesis that compromising the integrity of a distribution system can lead to problems (Williamson, 2002) is plausible enough to warrant attention and analysis. Today, similar vertical restrictions are common: How often does one see “sold only at authorized dealers” mentioned in an advertisement of high-quality automobiles, loudspeakers, or wrist watches? We speculate that TCE’s theoretical contributions for explaining the efficiency reasons for such practices may well have something to do with what we observe today in practice.

What is going on here? The divergent views can be understood by examining the premises that are used in addressing the vertical integration question. In reasoning terminology, what are the implicit and explicit warrants we use in drawing conclusions from our observations (Toulmin, 2003)? Williamson (2002) commented that the conclusion of vertical-integration-as-monopoly gains the warrant if one approaches the question using the conventional (industrial organization) economic theories of the time. Williamson (2002) further concluded that the Supreme Court’s ruling rested on two primary premises: thinking of the firm as a production function, and approaching industries using the structure–conduct–performance paradigm. These views were both established and privileged theories in the mid-20th century, and were adopted as warrants in policy making. But Williamson (1985: 188–189) saw these premises as too restrictive for a comprehensive evaluation: “The government’s case, which eschewed transaction cost features in favor of the firm-as-production-function construction, missed a great deal of what was relevant in order to reach an accurate economic assessment of what was at stake.” Understanding the costs associated with transacting, Williamson argued, requires an appreciation for firms as organizations, not as production functions. In contrast with hikers and tigers, these are the kinds of analogies that are fruitful in developing an understanding of vertical integration as an organization design as opposed to a market power phenomenon. This premise resides at the foundation of Williamson’s (1985) view of the firm as a governance structure, which has become one of the most influential and commonly applied analogies in organization economics.

**Exactly How Much Is at Stake?**

Economic transactions are ubiquitous, and a balanced management scholar needs to develop an understanding of what is relevant about these transactions, and in particular, of situations in which engaging in transactions requires special attention due to various complicating factors. This understanding can, of course, be based on many different theories, but the merits of TCE in particular are noteworthy. TCE emphasizes that transactions do not occur automatically, they always have a (transaction) cost associated with them. For example, drafting a buyer–supplier contract is an example of an ex ante transaction cost; enforcing the contract on a daily basis is an example of an ex post transaction cost. These costs have far-reaching consequences to economic and organizational fundamentals, such as the scope of the firm. In simple transactions, these costs are negligible, but in others, they are high enough to warrant attention—not just of the contracting parties but from broader sets of stakeholders. In addition to the Schwinn case, Williamson (2002) made observations on the
The Schwinn case shows that understanding, in its entirety, is a challenging feat even for the U.S. Supreme Court, and indeed, Williamson (1985: 38) noted such understanding is rarely realized.

WHY THE NEGATIVE REPUTATION?

A thorough reading of the TCE literature reveals that its primary objective is to seek a balanced understanding of complex phenomena, to consider issues from all sides, and to arrive at a way of arranging contractual relationships in a way that avoids waste. Further, as the Schwinn example shows, when the Supreme Court suspected foul play and ruled accordingly, the emerging TCE scholar gave managers the benefit of the doubt, just to make sure all bases and plausible explanations would be covered and the complex problem did not get a simplistic (biased) treatment. So why does TCE have a bad reputation among some management researchers? Only those who criticize TCE know why they are doing it, but let us explore here some potential reasons for misguided critiques of TCE in particular.

First, it takes considerable effort to develop a thorough understanding of Williamson’s (1975, 1985, 1996b) main TCE works. Many terms are esoteric and not used in other theories of organization: asset specificity, small-numbers bargaining, fundamental transformation, weak-form selection, irremediableness, and discriminating alignment. Understanding even the basic concepts, let alone their interrelationships, can be a daunting task. It is also the case that much of the terminology invites unnecessarily negative connotations: market failure, opportunism, the holdup problem, and the use of hostages to support exchange. We cannot avoid asking: “Is the excessive focus on opportunism in TCE critiques simply due to the fact that it is the first and most readily understood term?” It takes considerably less skill to declare that opportunism is an overly negative premise than to comb through a dozen obscure concepts and try to understand how they are used together to analyze a complex managerial decision. In the words of Elbow (1973), it is easier and more tempting “to play the doubting game” (to seek flaws) than “to play the believing game” (to seek a genuine understanding of the argument on its own terms).

Reading the critique of TCE, we conclude that much of it arises from selective interpretation. Further, if critique is based on the false premise that the hiker story in Ghoshal and Moran (1996) is a proper analogy, what exactly is being criticized? Aside from false analogies, Foss and Klein (2010) noted that some critiques directed at TCE are really critiques of modern microeconomics, not TCE. More generally, some of the critiques toward economic theories tend to treat very diverse theories as commensurate and monolithic. As a parallel, imagine someone writing a general critique on, say, string theory and then dismissing the entire field as a bad analogy to biology.
of institutional theory or network analysis, TCE is a distinctive theory that requires judgment based on its own terms. To make the distinction between TCE and economics clear, TCE is sometimes referred to as transaction cost theory (Mahoney & Pandian, 1992) or transaction cost analysis (Rindfleisch & Heide, 1997). TCE involves economizing, but this is not synonymous with economics. Just like socializing is not sociology.

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Another source of the bad reputation is more subtle. Many critical appraisals of TCE are not so much critiques as they are suggestions for alternative viewpoints. The common theme in these critiques boils down to declaring that “TCE ignores X.” Depending on who presents the argument and from what point of view, X may be production costs, trust, the decision-making process, firm heterogeneity, social structures, capabilities, and so forth. Alternative viewpoints are important, but how can failure to incorporate everyone’s favorite concepts be a shortcoming of a theory?

Last, in trying to make sense of the large number of citations to Ghoshal and Moran (1996) in particular, it is plausible that they result from the article having become a key reference in a critical narrative that targets economic approaches to management theorizing and business school education. This narrative has reconstructed and redefined TCE as a theory that condones not only self-interest, but also exploitation, greed, and dishonesty. Many critical evaluations of TCE echo this same sentiment. We can only guess what the motivation behind this narrative is, but then again, it is ancillary to our argument. What is relevant and not conjecture is that the reconstruction is based on an interpretation of TCE that is a caricature at best and a serious distortion at worst. We elaborate on this point in the following.

Opportunism Re-Examined

One sometimes hears the argument that TCE builds on a “Machiavellian logic,” where managers are advised “to get them before they get you,” much like Machiavelli advised the prince to respond to opportunism with reciprocal, pre-emptive opportunism. We hardly need to observe that this would constitute a horrible premise for management education. Williamson did make note of Machiavelli in his discussion of opportunism, but many scholars who draw parallels between Machiavelli and TCE miss the punchline: Pre-emptive opportunism is “a very primitive response” (Williamson, 1985: 48). In contrast with “the primitive prince,” the wise prince seeks both to give and to receive credible commitments (a central TCE term) to safeguard the relationship. This response—call it “positive Machiavellian logic”—is reasonable and something all of us embrace in the course of our daily lives, particularly when the stakes are high. The car dealership will not sell you a car on a handshake; instead, you are asked to provide a credible commitment in the form of a down payment. Accepting the down payment in turn obliges the dealer not to sell the car to anyone else. Both state and federal legislation protect consumers against fraudulent dealer behavior, so in this case the credible commitment on the part of the dealer arises automatically from the institutional environment. Sometimes these reciprocal acts to safeguard the exchange are discussed in the economics literature under the unnecessarily unsympathetic rubric of “exchanging hostages” (Schelling, 1960), even though that is exactly what they operationally are. Metaphors aside, the key message in TCE is that as much as possible, safeguards should be considered ex ante, not ex post. Most of us know from experience that fixing problems after the fact is always more time consuming and expensive than being forward looking in advance. Without mutual credible commitments, many transactions would simply not take place.

What exactly is the assumption about opportunism in TCE? Let us state the obvious and work from there toward the less obvious. It would be unwise to ignore the fact that unpleasant things may happen, sometimes in situations in which a lot is at stake. In the oil industry, assets used in different parts of the value chain are highly specialized. If one firm owns the oil fields, another the pipelines, and a third the refineries, each firm places itself at considerable risk, because one firm has the opportunity to take advantage of the asset specificity incurred by

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1 AMLE Editor Christine Quinn Trank (personal communication) makes the point eloquently: “The distortions and selective interpretations get amplified, repeated, simplified, caricatured, and before you know it, whatever TCE was, it is no longer. The narrative of business school critique has redefined it.”
another. In TCE, this is known as the holdup problem (Goldberg, 1976; Klein, Crawford, & Alchian, 1978). The potential for economic holdup is a real problem anyone engaging in serious risk analysis must consider, and this potential helps explain why firms in the oil industry integrate vertically: to avoid being exposed. More generally, TCE considers governance problems head on and seeks both ex ante (prevention) and ex post (correction) feasible solutions. If not for such efforts, we would likely face more, not fewer, problems.

Acknowledging the holdup problem is not the same as assuming that value chains are rife with economic actors looking to take advantage of others. Most of us trust exchange partners, and for a good reason: We have every reason to believe they behave honestly in a competitive environment. At the same time, it is simply a fact that sometimes economic actors do behave opportunistically and decide to take advantage of their supplier or customer. Further, because investments in a long-term buyer–supplier relationship can over time become relation specific, a dishonest party may see an opportunity to exploit specificity. But according to TCE logic, because such thinking is a short-sighted primitive response that causes all kinds of inefficiencies, it is an outcome to be avoided. The holdup problem signals failure: The contracting parties “[have not invested] efficiently in the relationship” (Wickelgren, 2007: 127). A potential holdup problem turning into a real problem is an indication that TCE’s prescriptions have not been followed: Mutual credible commitments that support the exchange relationship have either not been made or have proved inadequate (Williamson, 1983).

We must be clear about what opportunism means in the TCE context. Ferraro, Pfeffer, and Sutton’s (2005: 10) claim—and many similar claims—that self-interest seeking, with guile, is something that “proponents of transaction cost economics assume to be prevalent among economic actors” is incorrect; critics are confusing a theoretical premise with an empirical generalization. Let us try to correct the record by quoting Williamson from his acceptance speech for the Nobel Prize in 2009:

Most people will do what they say, and some will do more, most of the time without self-consciously asking whether the effort is justified by expected discounted net gains . . . But while accurate descriptions of what is going on “most of the time” are plainly essential, much of what is interesting about human behavior in general and organizations in particular has reference not to routines but to exceptions.

If anything, TCE assumes that opportunism, as an empirical phenomenon, is the exception rather than the rule. At the same time, even the exception warrants attention and safeguards when the stakes are high. It should be noted while TCE acknowledges that opportunistic transacting partners are the exception, the challenge, due at least in part to bounded rationality, is that these opportunistic types cannot be identified ex ante. As far as what TCE condones and promotes, a second quote makes the point succinctly (Williamson’s interview with sociologist Richard Swedberg, 1990: 126): “[T]he world should not be organized to the advantage of the opportunistic against those who are more inclined to keep their promises.”

Are you insulted at the airport because they require an honest person like you to pass through the metal detector? If you answered no, your basic assumption about human behavior is about as “pessimistic” as that of TCE; if you answered yes, we predict uncomfortable travel experiences in your future. Every reasonable person waiting in line at airport security fully understands and accepts that airports are organized to the advantage of the honest: The objective of airport security is to make the honest feel safe and the dishonest seriously uncomfortable. The safeguards are in place because of potential, and luckily, extremely rare, exceptions. Opportunism at the margin—we know it exists—is why security is needed. We find TCE sufficiently analogous. To conclude that this somehow amounts to a pessimistic view of human agency or provides the basis for “bad management theory” is a non sequitur. TCE starts at the question any reasonable

4 Let us not forget that the contractual if not legal obligation of executives is to look out for what benefits their own organizations. In this sense, self-interest is not merely a human condition, it is an institutionalized prescription. Pessimistic or not, a rigorous scholar trying to understand authentic organizations cannot ignore the duty of loyalty that executives and board members have to their organizations.

5 The claim that TCE condones or encourages opportunism rests on a very strange logic. Consider two examples for comparison: (1) We teach subjects such as accounting fraud in business schools. Does someone mistake these for “how-to” courses? (2) Consider insurance, which is all about exceptions; we spend a lot of time thinking about insurable risks, researching them, and teaching about them. Does this mean that we condone fires and other calamities? Of course it does not. Safeguards in TCE are a form of insurance.
person asks just about every day: How do I behave in a situation where a lot is at stake? Uncertainty avoidance is a central behavioral principle we typically follow.

Now, if TCE seeks to privilege the honest and discourage the dishonest, how is this anything but ethically sound and responsible management practice? With all our knowledge about and insight into societies, firms, and individuals, wouldn’t ignoring the potential for opportunism lead to bad management practice? If one thinks back to the corporate scandals of Enron, WorldCom, and Tyco, it is certainly more plausible to conclude that paying heed to the tenets of TCE would have worked toward avoiding or at least mitigating the problems, not creating or exacerbating them. To insinuate that exposure to “bad management theories” has something to do with the fact that Harvard MBA and former CEO of Enron Jeffrey Skilling was found guilty of conspiracy, insider trading, securities fraud, and lying to auditors, is about as unfounded as blaming driver’s education for drunk driving. Quite the opposite, it is plausible that those with an MBA degree understand better than many of their peers that securities fraud is unethical; they certainly know it is illegal. How they then choose to behave in actual future decision situations is beyond our control. Perhaps the best business school instructors can do is to ensure that their students leave the classroom adequately informed.

In sum, we maintain that the potential for opportunism is and always should be considered when negotiating contracts in which a lot is at stake. We also agree with Williamson (1993) that if opportunism is to be ignored, it must be done explicitly, working out the ramifications. To candidly acknowledge opportunism at the margin is not pessimism, it is common sense. To attenuate opportunism in turn, is a noble and moral endeavor, but this is precisely what TCE seeks to achieve. Aside from opportunism, many of the inefficiencies in economic transactions can result simply from honest disagreements, the cost of which can be significant enough to warrant attention (Alchian & Woodward, 1988). When the parties to a contract represent different legal entities (different firms), they simply do not have a common objective, which alone can be sufficient to lead to disagreement and inefficiencies. Managers’ efforts on behalf of their firms are not just inclinations, but also contractual obligations and other forms of safeguards. For the rest of us, it is a basic human condition: “It is part of human nature to care more about consequences that affect those we are close to rather than others” (Freeman, Harrison, Wicks, Parmar, & de Colle, 2010: 283). While any reasonable person sympathizes with attempts at raising the standards, TCE cautions against embracing wishful thinking as a premise and encourages scholars to focus on remediable problems. Thinking that changing human nature falls within the scope is pretentious and ineffective.

**USEFUL TCE CRITIQUE**

Our aim is certainly not to suggest that TCE is beyond critique or that it has no shortcomings. It is just the opposite: Critique is essential for the progress of a theory (e.g., Lakatos & Musgrave, 1970). The fact that TCE has received a lot of critical attention is in our view both important and encouraging. But here, it is important to make the distinction between two kinds of critiques (e.g., Ketokivi & Mantere, 2010). In what could be labeled an endogenous critique, one evaluates an argument without rejecting its basic premises. The goal is to assess the logic of the argument for its internal consistency and empirical merit: Do the claims plausibly follow from the premises? Are the claims supported by empirical observation? Is something missing? In an exogenous critique, in contrast, the critic rejects one or more of the key assumptions the argument makes. Accordingly, the exogenous critic is typically not interested in the consistency and plausibility of the argument, but rather, focuses on whether the argument is worth entertaining in the first place. At the end, the exogenous critic often dismisses the argument not as incomplete but as inadequate, even misguided. Table 1 includes a summary of what we consider the central exogenous and endogenous critiques of TCE. Ghoshal’s (2005) critique would clearly fall into the category of an ill-informed exogenous critique.

Certainly, not all exogenous critique is ill-informed. In fact, much of it is thoughtful and warrants TCE scholars’ attention. It appears that the majority of TCE critique is indeed exogenous: Critics suggest alternative independent or dependent variables, point out boundary conditions, et cetera. But what, if anything, should a scholar do when faced with an exogenous critique (this question is of course relevant to everyone, not just the TCE theorist)? While an exogenous critique can be useful food for thought, it often fails to achieve little more than the obvious. We know that a theory that seeks
to address complexity parsimoniously does not apply to all empirical situations or variables of interest. We hardly need to be reminded that there are variables other than transaction efficiency that merit attention. Just like any theory, TCE constitutes a point of view. Carter and Hodgson (2006: 461) take Williamson’s (2000: 605) position that TCE is “an empirical success story” too far by concluding that if this claim is true then TCE has “triumphed over rival explanations of the nature of the firm.” This conclusion is a non sequitur: All that the empirical adequacy of a theory (van Fraassen, 1980) establishes is that the theory has led to useful empirical predictions, which is clearly what Williamson (2000) meant by empirical success. No comparisons to other theories are made in establishing empirical adequacy. Whether theorists should pit theories against one another in empirical research is an interesting question (see Platt, 1964). This may sound tempting, but when two theories make use of different kinds of theoretical (unobservable) terms, it is impossible to test them against one another in a methodologically sound fashion (e.g., Boylan & O’Gorman, 1995).

Sometimes an exogenous critique is simply a reflection of research policy, not theory or methodology. It is true that unlike many other economic theories of the firm, TCE is difficult to formalize as a mathematical model. Some consider lack of formalization a shortcoming. But what exactly are the methodological or theoretical reasons that privilege formalization at the epistemological foundation of research on governance? The downside of formalization is well known: In discussing the merits of their two-party exchange model of vertical integration, Grossman and Hart (1986: 710, italics added) acknowledged that “[a]ny real industry is, of course, far more complex than our model.”
Expressing a preference for mathematical modeling seems more like promotion of a specific epistemological virtue (of formalization) at the expense of another (empirical adequacy). Needless to say, suggesting that formalization should trump empirical adequacy has little to do with the substantive critique of a theory. More generally, we must be careful, because sometimes expressions of policy (preference) are indeed disguised—often probably inadvertently—as being grounded in theory or methodology (Ketokivi & Mantere, 2010). For example, to claim that organizational boundaries are driven more by firm-level competences than transaction cost considerations remains a statement of policy until one is able to consistently corroborate this empirically (e.g., Walker & Weber, 1984).

From the point of view of advancing TCE (or any theory), an endogenous critique can be useful as it raises research questions that can be tackled within the same research program (Lakatos' term for a stream of research that focuses on a given research question; see Lakatos & Musgrave, 1970). A detailed discussion of such a critique is outside our scope here, but let us briefly discuss some part of it.

One of the key assumptions in TCE is bounded rationality, which implies that it is difficult for decision makers to be forward-looking in contracting. While TCE considers both ex ante and ex post transaction costs, its distinctive focus is on the latter. In contrast, agency theorists suggest that all of the relevant action occurs ex ante, before the contract is signed. Further, instead of assuming that bounded rationality is a fixed background condition, we should recognize that contracting capabilities may differ drastically across firms and individuals (Argyres & Mayer, 2007). Effectively turning an assumption into a variable can certainly be used to elaborate TCE (see also John, 1984).

Another endogenous critique has pointed out that the unit of analysis—the individual transaction—presents problems. Argyres and Liebeskind (1999) maintain that governance decisions in practice are often inseparable, which means that using the individual transaction as the unit of analysis presents a problem. Again, this critique does not reject the basic logic of TCE, but does point to new directions in terms of empirical models in particular. To be sure, modeling interdependencies across transactions can be incorporated into models, and does present a potentially important avenue for future research. Indeed, Williamson (1985: 393) acknowledged this opportunity as well: “Although transaction cost economics insistently addresses both ex ante and ex post conditions of contract (sometimes referred to as the study of contracting in its entirety), it normally examines each trading nexus separately. Albeit useful for displaying the core features of each contract, interdependencies among a series of related contracts may be missed or undervalued as a consequence.”

Last, TCE works out of the premise that in complex transactions, markets may either fail or at least may be comparatively less efficient than hierarchy, which means the complex transaction is either prohibitively expensive or impossible to carry out using the market (the price system) or is comparatively inefficient as the key coordinating mechanism. Indeed, this logic is what gives rise to firms in the first place (Coase, 1937). Few people dispute this logic, but some TCE critics—including Williamson himself (e.g., 1985)—have noted that the market failure literature is indeed much more developed than the bureaucratic failure literature. Again, this critique presents interesting opportunities for future research.

**TCE AS A CONSTRUCTIVE STAKEHOLDER THEORY**

In the final chapter of one of the definitive recent treatments of stakeholder theory, Freeman et al. (2010: 281–285) present six Principles of Stakeholder Capitalism. Here are the first three:

- **Principle 1 (stakeholder cooperation):** “Value can be created, traded, and sustained because stakeholders can jointly satisfy their needs and desires by making voluntary agreements with each other that for the most part are kept.”
- **Principle 2 (stakeholder engagement):** “To successfully create, trade, and sustain value, a business must engage its stakeholders. Almost every business transaction involves customers, suppliers, communities, employees, and financiers.”
- **Principle 3 (stakeholder responsibility):** “Value can be created, traded, and sustained because parties to an agreement are willing to accept responsibility for the consequences of their actions. When third parties are harmed, they must be compensated, or a new agreement must be negotiated with all of those parties who are affected.”

Let us examine these principles in light of TCE. Principle 1 emphasizes safeguarding a contractual relationship in a context where exchange is voluntary and a party to the transaction may not keep their promise (i.e., acts opportunistically). Safeguards may not only be contractual, but could also include
social sanctions and opportunities for future business. Principle 1 is thus fully consistent with TCE. Principle 2 focuses on stakeholders giving and receiving credible commitments, which we think is a useful way of elaborating on how “to engage” relevant stakeholders: “by putting your money where your mouth is.” Last, Principle 3 is about compensation when someone is harmed. Here, TCE is, in our view, one step ahead of this version of stakeholder theory, because TCE specifically emphasizes the importance of avoiding harm and anticipating problems with foresight, for example, by stipulating, ex ante, arbitration and mediation proceedings for potential conflicts.

TCE is therefore fully consistent, even complementary, with these fundamental principles of stakeholder theory, which leads us to conclude that TCE can indeed be applied as a constructive stakeholder theory. Specifically, TCE is a stakeholder theory of governance that emphasizes the long-term cooperation of the key stakeholders (whomever they happen to be in the specific setting) in a way that enables economic transactions with minimal waste.6 We examine the implications of this logic further below.

How Does TCE Complement Extant Stakeholder Thinking?

While many approaches to stakeholder theory emphasize the role of owners and employees, TCE compels us to acknowledge that managers are a privileged and influential stakeholder group. One of the key enablers of corporate malfeasance—and we have to come to terms with the fact that there is plenty of it—is the fact that boards of directors are often at a huge informational and expertise disadvantage vis-à-vis top management. Many CEOs choose their boards, not vice versa. They also often chair the board and set the agenda for board meetings. Board members are busy people who spend the vast majority of their time attending to issues other than their board assignment—think of Disney’s CEO Robert Iger as an Apple board member. We also have evidence that in powers struggles, top management tends to have the advantage over the board (Gillespie & Zweig, 2010). In light of these realities, we should probably not be surprised that “many observers regard the credibility of the board in practice as a pathetic fiction” (Williamson, 2008: 263). This may further help understand why U.S. lawmakers, for example, have sought to remedy informational asymmetries and power imbalances with legislation of unprecedented vigor (e.g., Sarbanes-Oxley Act of 2002; Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010).

However, TCE theorists in general and Williamson (2008) in particular are not satisfied with conceding a pathetic fiction. They have been hard at work seeking solutions for several decades. Still, any remediable solution to a problem and the foundation of any effective stakeholder perspective must start with the realization of the privileged position of the top management.

Agency theory has made some headway, but success seems modest. One limitation is that agency theory builds on the (unrealistic) assumption that complete contracts—albeit with asymmetric information—with a mix of economic bonding and behavioral monitoring are optimal solutions to the agency problem. We do not think it unfair to ask: “If optimal solutions can be found in contracts with economic bonding incentives and monitoring, why are we witnessing so many problems?” TCE proposes that we work out of the more realistic assumption that all contracts are incomplete. Indeed, in reading some critiques of TCE, one cannot avoid the conclusion that they are more critiques of agency theory than TCE. At the same time, TCE and agency theory represent vastly different approaches to economic analysis: They focus on different units of analysis, build on different assumptions, and lead to different kinds of predictions. Indeed, the two are fundamentally different at their very foundation: TCE views the firm as a governance structure, while agency theory views it as a nexus of contracts. In our view, TCE connects more strongly to organization theory in particular.

What are some practical implications that TCE can offer to stakeholder management? The Academy of Management appropriately reacted strongly to the corporate scandals that took place at the turn of the millennium. Notable management scholars strongly argued that we cannot assume the role of bystander (e.g., Gioia, 2002). In an essay exploring what could be done about this problem, Kochan (2002: 141) maintained that

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6 This idea is not novel. Stakeholder theorists Donaldson and Preston (1995: 88) wrote: “The theory of property rights, which is commonly supposed to support the conventional [shareholder supremacy] view, in fact—in its modern and pluralistic form—supports the stakeholder theory instead.” We conjecture that most outsiders to TCE (perhaps even some insiders) may view TCE through a shareholder lens. Our arguments here are parallel to Donaldson and Preston (1995) in maintaining that TCE, properly interpreted, is consistent with stakeholder theory.
boards of directors should be opened to worker representatives, in particular to those “who invest and put at risk their human capital.” How many of us are aware that this is not only perfectly in line with TCE, but that Williamson had already made this very point almost 10 years earlier? “[T]he first and simplest lesson of transaction cost economics is that corporate governance should be reserved for those who supply or finance specialized assets to the firm … The possibility of using the board of directors as a security instrument for some or all of these constituencies warrants consideration” (Williamson, 1991: 86). Again, TCE offers a useful way to think about the notion of “risking human capital” operationally through human asset specificity: How strongly is the fate of a specific employee or employee group tied to the fate of the organization? Governance decisions should provide more safeguards for high-specificity human capital, which directly links to higher employment risk. Indeed, it is even possible to obtain at least rudimentary numerical estimates of the degree of specificity by asking questions such as “How much would the salary of this employee group drop if they had to seek employment elsewhere?” If the answer is “a lot,” the importance of credible commitments toward that specific employee group is more likely to be paramount. All of us, as employees, engage in such risk calculations. How many of us have not at some point in our lives asked “What would happen if they let me go?” TCE not only highlights the importance of understanding specificity, it also helps us think of organizational designs that secure the cooperation of stakeholders that exhibit such specificity (Blair & Stout, 1999; Hansmann, 1988). While the majority of management scholars got interested in governance questions in a reactive manner (many of us in response to corporate scandals), Williamson (1985, 1991) had already addressed key questions proactively, with suggestions for remediable solutions.

**TAKING A CONSTRUCTIVE TCE TO THE CLASSROOM**

In this final section, we discuss some implications of TCE that is used in MBA and executive classrooms. Currently, some tend to think of TCE as the theory of “the make-or-buy decision” and that the primary domain of application is in vertical integration and outsourcing. This is indeed the most common empirical question that TCE scholars have asked, and the make-or-buy decision is sometimes referred to as the “paradigmatic TCE case” or “canonical problem” (e.g., Williamson, 1996b). We have observed that even some proponents of TCE do not do justice to TCE in that they discuss it not as a general theory of contracting but using only one of its empirical applications, the make-or-buy decision. This decision is further typically discussed in the context of the manufacturing firm, where the choice is between making or buying a given component to be used in the final assembly. Ironically, such narrow treatment of TCE as pertaining to the manufacture of physical products has the same outcome as some critiques discussed here: It leads to contrived understanding. Developing a broad-based understanding of issues presents a challenge to all—simplification seems like a general natural inclination (e.g., March, 1994). But insofar as the goal is to understand a complex issue, we must resist the inclination, a general premise embraced in TCE as well: “[T]he object is not to describe human actors in a user-friendly way but to understand complex economic organization” (Williamson, 1993: 99). TCE is not user friendly, but for a good reason.

**“TCE is not user friendly, but for a good reason.”**

One of the useful features of TCE is that it applies not only to intermediate product markets (i.e., outsourcing, hybrid organizations such as alliance and equity joint ventures, and vertical integration), but more broadly to many empirical questions and phenomena where governance of contractual relationships is relevant. Here are just some examples:

1. Governance of financial relationships: Under what conditions does debt (versus equity) financing make sense? Indeed, for Williamson (1988), this question is not just about financial management but a governance decision.
2. Governance mechanisms in organization design: For example, what are the advantages and disadvantages of the multidivisional organization (Williamson, 1975)?
3. Governance of the modern publicly traded corporation: Who should have a seat on the corporation’s board of directors (Williamson, 1991)?
4. Matching governance mechanisms to transactions: For example, which organizational form (public corporation, professional partnership, etc.) is suitable for which context (Williamson, 1991)?
5. The scope of the firm: When does it make sense to diversify internationally? When is product diversification desirable? When does it make
sense to integrate horizontally as opposed to vertically (Williamson, 1985)?
6. Governance of labor markets: What kinds of employment contracts should a firm have? What are the ramifications for union organization (Williamson, 1991)?
7. Governance of noncommercial organizations: For example, how should legislatures be governed (Weingast & Marshall, 1988)?

The utility of TCE with regard to these questions is notable, because on many of the issues (much like in the Schwinn case), TCE offers an explanation or prescription that either complements or challenges other accounts. TCE rarely repeats what other theories prescribe, instead, it offers a useful counterpoint (e.g., Kochhar, 1996; Santos & Eisenhardt, 2005). TCE helps us think of pertinent questions “outside the box” and realize how fundamentally our underpinning assumptions act as warrants that support our conclusions. A well-established philosophical fact is that conclusions can never be based on data and observation alone. This is crucial not only for transparency’s sake but also for the reason John Stuart Mill (1882: 981) aptly observed over a hundred years ago: It is not the syllogistic form of our reasoning (we usually get the form right), but the false premises we introduce that lead us astray. We can learn much from TCE just by examining its intellectual ethos, without even invoking any of the contents of the substantive theory itself. This is not to say other theories cannot offer the same, but of all the theories we are aware of, TCE gives more self-conscious attention to the underpinning assumptions. Many of us can cite the TCE assumptions by heart, but how about the assumptions underlying agency theory, structural contingency theory, or the resource-based view? There is something about TCE that invites management scholars to make their assumptions explicit. Ironically enough, perhaps being self-consciously transparent about the assumptions is one reason for the criticism of TCE; implicit assumptions are obviously more immune to criticism. At the same time, being explicit about one’s assumptions is a feature of good theorizing, and it certainly should find its way to the classroom as well: “[A] thoughtful consideration of the underpinning assumptions is often sufficient to reproduce insights gained from piles of experience and evidence” (Pfeffer & Sutton, 2006: 24).

Most business school instructors have probably felt the pressure to offer simplistic and unambiguous formulations in the classroom. Polemics tend not to fare well with students. This is not to say all students prefer simplicity, but the phenomenon is common enough. However, this approach ultimately does a disservice to our students. TCE is a perfect antidote to myopia, because it encourages us to re-think existing problems and prescribed solutions. One of the authors of this article gives the Schwinn case to MBA and executive students, revealing only the description of the case and the Supreme Court’s decision, not Williamson’s (1985) critique. The students’ task is to think in groups of ways to challenge the Court’s decision. Students are almost always able to formulate at least a rudimentary TCE argument. The ability to discover in group-work a counterpoint to an existing argument leads to an authentic learning experience, not to mention the satisfaction one gets from feeling one has just out-smarted the Supreme Court. A similar analysis can be performed on the oil industry value chain: What are the different elements of the value chain, who owns which parts, and why? Under what conditions will an oil company want to own not just the oil fields and the refineries but the pipelines as well? Should oil companies own oil tankers? In analyzing value chains, students learn to appreciate the difference between strategic and economic aspects of decisions (cf. Williamson, 1999b): Why is it generally impossible for oil companies to implement an “asset-light” strategy? In contrast, why is such strategy feasible for companies such as Marriott, which does not carry on its balance sheet the buildings that house its hotels? Many students are inclined to “see strategy,” when they should “see organization”—TCE can help understand why.

On the topic of board composition, consider starting a classroom discussion on governance by showing a slide that displays the composition of Apple’s board of directors. Why these specific people? Why Disney CEO Robert Iger? Why former Vice President Al Gore? The usual response from students is that these people “help the company” in various ways. But what is the essence of this help? Whose interests are being privileged? Why are employees not represented on Apple’s board? In contrast, why do Joseph Ashton (a retired VP of United Auto Workers) and Admiral Michael Mullen (former Chairman of the Joint Chiefs of Staff) sit on the board of General Motors? Many students have been formally taught agency theory, so they are comfortable with discussions on the importance of securing the rights of the shareholders, the contractually disadvantaged stakeholders who have put their money at risk but get “their only bite at the apple” at the distribution of the residual. Students also readily understand the importance of aligning
incentives: Managers have poorly diversified career portfolios and tend to be more risk averse than owners who have all the degrees of freedom to diversify their investment portfolios as they see fit. But TCE takes the discussion on boards further by raising the question of credibility in broader terms than just residual claimants. For instance, employees who contribute to firm-specific knowledge must be brought to the governance agenda, because the employment contract alone may not be enough to secure their cooperation (Klein, Mahoney, McGahan, & Pitelis, 2012). TCE can be used as the foundation to explore how this challenge can be tackled and who the key stakeholders are. Note that if specificity is considered, shareholders are not the only stakeholders who bear residual risk. This constitutes an important counterpoint to agency-theoretic thinking about governance. TCE is fully consistent with the general stakeholder theory idea that “[t]he rights of shareholders are prima facie at best, and cannot be used to justify limiting the freedom of others without their consent” (Freeman, Wicks, & Parmar, 2004: 365) Therefore, when Freeman, Wicks, and Parmar (2004: 365) write that “[s]hareholder rights are far from absolute, regardless of how much economists talk about the corporation as being the private property of the shareholders,” we need to understand that the economists mentioned here certainly cannot include anyone who takes TCE seriously.

CONCLUSION

We discussed the logic of TCE in nontechnical and practical terms, but in accordance with the TCE ethos, we did so in its entirety. We maintain that a thorough understanding of TCE serves two important purposes. First, to engage in useful critique of any theory, one must show a thorough understanding of it. Second, a thorough understanding can help us take TCE to the classroom in a constructive manner. Of all the theories of organization, we find that TCE asks some of the most insightful questions, questions that can lead us toward a broader understanding of managerial action. Such understanding serves us well when the stakes are high.

In closing, let us revisit Ghoshal’s (2005: 75) claim that “bad management theories are destroying good management practices.” The fundamental reason for why we find this assertion so problematic is not the associated misrepresentation of TCE, but the fact that the subject in the sentence is a theory, not a person. To us, Ghoshal’s (2005) general position on “bad theories” is ultimately an anthropomorphic fallacy. We find it unfathomable that when we walk into our classrooms, our theories accompany us as distinct agents of their own, that bad theories have the power to contaminate our teaching, and ultimately, all this works toward eroding managerial ethics. We should give ourselves, our peers, and our students a little more credit than that: The only agents that have the power to build (or destroy) good management practices are human beings individually and collectively. Thus far, neither of the authors of this article has witnessed the destructive power of TCE, in the classroom or outside it. Perhaps this is at least partly due to the fact that in our own classrooms, we choose to teach TCE as a constructive, useful theory. Oliver Williamson’s collective works have certainly given us more than enough reasons to do so.

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