



## Transaction cost economics in global sourcing: Assessing regional differences and implications for performance

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### ABSTRACT

This paper addresses two gaps in current research on transaction cost economics (TCE): first, the fundamental claim suggesting that firms that align their governance structure to transactions according to TCE perform better than those that do not, and second, the application of TCE to global sourcing transactions. A research model is presented and evaluated using a set of 150 relationships between Swiss buyers and foreign suppliers. The findings suggest that there are significant differences in how transactions and governance structures are aligned with varying performance and with suppliers from Western Europe as compared to suppliers from other regions.

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### 1. Introduction

Transaction cost economics (TCE) has been an established concept for analyzing economic organizations for several decades. The theory – based on Coase's (1937) work about the nature of the firm and later advanced by Williamson (1975) – is centered around the two notions transaction costs and governance structures. The basic claim is that an appropriate alignment of transactions with the corresponding governance structure will allow an organization to economize on its costs. Originating as a positive theory in economics, the concept has been transferred to the area of business administration, where it is applied as a normative concept to improve decision making of managers (Ghoshal and Moran, 1996; Masten, 1993). The theory has been tested empirically numerous times and summarized in several meta-studies (David and Han, 2004; Macher and Richman, 2008). In the majority of cases, existing studies focus on empirical testing of the link between characteristics of transactions – most prominently asset specificity and uncertainty – and governance structure. However, the most intriguing proposition from the normative point of view has received only minor attention up to now. That is the assessment of the economizing effect (David and Han, 2004), or put differently, whether transactions with a proper alignment of transactions to governance structures according to TCE predictions exhibit better performance than others.

A recent publication by Williamson (2008) pointed to the need for further elaboration of the link between TCE and Supply Chain

Management (SCM). In accordance with commonly accepted interpretations of SCM (SCOR, 2008), Williamson mentioned procurement as one of the major elements in SCM. Procurement is of particular importance in manufacturing, as several tendencies have led to an increased weight of this business function (Degraeve et al., 2000): Concentration on core competencies has decreased the depth of value added in many industries to below 50% (Jahns and Lück, 2005). At the same time, globalization has opened up new markets and possibilities for purchasing professionals, especially in low-cost countries (LCC). Therefore, companies today not only need to purchase more but also have to cope with a more global and heterogeneous environment. Williamson (2008) also recognized this problem: “Suppose, instead of a common boundary, that the exchange in question is between a U.S. firm and a foreign supplier or buyer. Additional complications arise if property rights are less secure and/or courts are less reliable in exchanges across boundaries. Such hazards need to be factored into the transaction cost calculus” (p. 12).

In practice many companies have had to learn that not all global sourcing endeavors turn out to be a success. In a study of the German metal and electrical industry, Kinkel and Maloca (2009) found that for every four to six enterprises starting to source from a LCC, there is one company that revises its decision within 4 years. The reasons identified for these relocations – sometimes also referred to as “backsourcing” or “backshoring” – are limited flexibility, declined or fluctuating quality, and unexpected coordination activities, among others. Expenses for unexpected coordination activities are generally categorized as transaction costs that emerge from coordinating the flow of materials and information from the supplier to the buyer and vice versa.

The rising importance of global sourcing thus poses new challenges for practitioners and the advancement of TCE theory alike. Even though this problem is known, empirical studies have

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often failed to take this additional requirement into consideration up to now. With this study we aim at strengthening the empirical foundation of TCE in areas that have previously been neglected and at examining its justification as a normative theory. The contribution of this paper consists in addressing two gaps in current research on TCE:

- First, we scrutinize a central tenet of TCE by examining the relation between alignment and performance in procurement transactions.
- Second, we analyze the alignment of transactions and their corresponding governance structures in the context of global sourcing.

Here we focus our attention on the manufacturing industry, where purchasing has become a decisive corporate function. The study is based on an empirical investigation of business relationships between Swiss buyers and suppliers from various countries.

The remainder of this paper is structured as follows: Section 2 introduces the underlying concepts of TCE and global sourcing. Section 3 describes the research model and the emerging hypotheses. Section 4 presents the applied methodology and data analysis. Section 5 displays the results. The last three sections discuss the findings, present conclusions and managerial implications, and point out limitations as well as avenues for future research.

## 2. On transaction cost economics and global sourcing

Our empirical investigation is based on the theory of TCE as well as global sourcing. This section presents these two concepts and discusses previous studies on these topics.

### 2.1. Transaction cost economics

TCE is based on two underlying key assumptions about human actors that can be summarized as bounded rationality and opportunism (Grover and Malhotra, 2003). These behavioral assumptions as well as complex market exchanges represent the main arguments for application of TCE in market economies (Williamson, 1981). According to Williamson (2008), “TCE aligns individual transactions with modes of governance so as to effect a transaction cost economizing match” (p. 14). *Transactions* are predominantly described by three dimensions—asset specificity, uncertainty, and frequency (Williamson, 2005). Asset specificity can be understood as “a measure of nonredeployability” (Williamson, 2005), or as the degree to which assets that support a particular transaction can be transferred to a transaction outside the exchange relationship. Uncertainty describes the extent to which transactions are subject to disturbances. Frequency describes the rate of reoccurrence of a transaction. It is sometimes neglected with the argument of focusing on repetitive transactions (Rindfleisch and Heide, 1997; Williamson, 1981) and has in general received less attention in empirical research (David and Han, 2004). Following classic TCE theory, transactions can be handled with different *governance structures* (Williamson, 1975). Governance structures – also referred to as modes of governance – are defined as “discrete structural alternatives that possess distinctive strengths and weaknesses in autonomous and coordinated adaption respects” (Williamson, 2008). They are responsible for coordinating the flow of materials, information, and services through steps in the value chain (Grover and Malhotra, 2003). A specific transaction between two subsequent partners in a value chain will therefore be handled with the governance structure in place at the given moment. Williamson distinguishes

three generic governance structures—market, hybrid, and hierarchy. The three structures differ in governance attributes such as intensity of the cooperation and coordination mechanisms (Grover and Malhotra, 2003). In TCE theory, the most paradigmatic case is a situation in which asset specificity and uncertainty exist, and where coordination mechanisms or safeguards between the partners are in place (Williamson, 2008). This situation is particularly prone to opportunistic ex-post behavior (Blomqvist et al., 2002). According to theory, the optimal choice for such cases is often a hybrid governance structure (Williamson, 2008). In reality – and especially for procurement transactions in manufacturing – most governance structures could probably be assigned to this type of situation (Hennart, 1993), and for this reason we will focus our attention on it. It is apparent that hybrid governance structures cannot be treated as a discrete alternative in practice. Instead, a whole range of slightly differing structures is encountered. This fact has been acknowledged previously; among others, Blomqvist et al. (2002) modeled hybrid governance structures as a “continuum of partnership options” (p. 7), and Bensaou (1997) spoke of the degree of interorganizational cooperation.

A multitude of empirical studies have tested various aspects of TCE (Williamson, 2008). The basic elements (such as asset specificity, uncertainty, or governance structures) have been operationalized in many different ways, revealing that there is much room for interpretation of TCE in various different fields and applications. In a review of empirical tests of TCE, David and Han (2004) found supportive as well as contradictive contributions and concluded that “a more thorough empirical grounding of the theory’s foundation is crucial to its future development” (p. 39). There has also been criticism from a conceptual perspective, whereby different authors raised doubts about the significance and validity of the theory. Blomqvist et al. (2002) and Seppälä et al. (2010) mentioned that classic TCE does not account for benefits of transactions and neglects the knowledge-based view that also considers evolving capabilities and knowledge of firms. A controversial discussion also emerged regarding the normative character of TCE. Whereas Masten (1993) argued that “managers would be well advised to heed those rules [TCE] and to factor transaction-cost concerns into their decision-making calculus” (p. 119), Ghoshal and Moran (1996) stated, “Williamson’s arguments ... are not only inapplicable to most decision-making situations in firms but, if so applied, are also likely to adversely affect their performance” (p. 16). This brings us to the core of the theory, which concerns the question as to whether aligning transactions with governance structures according to TCE does or does not pay off for companies. The question was raised previously by Rindfleisch and Heide (1997), and several papers claimed that performance is positively affected by conforming to TCE predictions without assessing the matter empirically (Chiles and McMackin, 1996; Dyer and Chu, 2003; Hennart, 1993; North, 1990; Roberts and Royston, 1997). To the best of our knowledge, only a handful of studies can be found that investigated the relation between alignment of transactions and governance structures with performance empirically (see Table 1).

Anderson and Dekker (2005) determined that in transactions that experience subsequent problems, fewer TCE-related attributes are considered than in transactions with few problems. From our point of view, the study is limited inasmuch as it assessed ex-post transaction problems and not actual performance and only covers transactions for IT products and services by Dutch small to medium-sized enterprises (SME). Brouthers et al. (2003) found support for TCE predictions when looking at overall exchange performance of entry mode choice that are in accordance with transaction characteristics. However, the examination was restricted to analysis of the governance modes “joint venture” and “wholly owned subsidiary” and only considered the

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