Scand. J. Mgmt. 21 (2005) 77–100

SCANDINAVIAN JOURNAL OF Management

www.elsevier.com/locate/scaman

Transaction organizations and transaction cost analysis: A theoretical investigation of the domain-expansion decisions of firms employing a mediating technology

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Abstract

We use the theory of network externalities in applying transaction cost economics (TCE) to inter-mediator transactions. We propose network specificity as an additional form of asset specificity associated with such transactions. Specifically, we identify and analyze two integration decisions that are distinctive to mediators and that both depend on network specificity: the network integration of nodes and the vertical integration of complement exchange activities. We derive some implications of this for managerial practice, public policy and further research.

Keywords: Transaction cost analysis; Mediation industries; Network externalities

1. Introduction

This paper applies the logic of transaction cost economics (TCE) to firms using the *mediating technology* and whose primary function is therefore 'the linking of clients or customers who are or wish to be interdependent' (Thompson, 1967, p. 16).

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0956-5221/$ - see front matter
doi:10.1016/j.scaman.2005.02.005

Henceforth we refer to such firms as mediators. They create value by providing network infrastructures and services for inter-customer exchange (Stabell & Fjeldstad, 1998), in order to reduce their customers' transaction costs. The organization types cited by Thompson (1967), i.e. banks, telephone companies, insurance firms and postal services correspond closely to those listed by Douglass North (1991) and North and Wallis (1982) as transaction organizations, and to those referred to by Economides (1996) as network firms. A common characteristic of them all is the impact of size on customer value (Katz & Shapiro, 1985; Thompson, 1967).

The purpose of the present paper is to investigate whether mediators,[1] as a prominent example of firms where network externalities have a strong impact on product quality, are exposed to transactional hazards that have not yet been addressed by TCE, and whether adaptations of the TCE conceptual tools are required. Four concerns motivate this study. First, economics (cf. Katz & Shapiro, 1985) and organization (Thompson, 1967) have both identified unique properties of mediators that have important implications for inter-firm relations. Second, mediators share some common types of interdependencies with their environment (Barnett & Carroll, 1987) that distinguish them from other firms, and these interdependencies have implications for economizing on transaction costs. Third, as a result of what the Berkeley sociologist Manuel Castells (1996) refers to as the rise of the network society, mediators are becoming increasingly important in the economy. Fourth, during the last 10–15 years the transaction service markets have been extensively deregulated. An important consequence of the deregulation is that most transaction organizations are expected to make strategic decisions, including decisions about the scope of their operations and the governance of their transactions.

Many types of firm have products that exhibit network externalities. Mediators exhibit two properties in particular that make them especially suitable for investigation. First, the primary service offered by mediators is to facilitate exchange within a network of customers. Hence network effects are fundamental to their value-creation, and their main transactions with other firms are connected with enabling such customer exchanges to cross organizational boundaries. Second, mediators are frequently involved in transactions with other mediators who offer complement exchange services in order to enable the coordinated exchange of objects by using multiple network layers. Interconnection transactions and inter-layer access transactions between mutually complementing exchange-service providers both imply a reciprocal dependency between the mediators, which in turn exposes them to an exchange hazard. We examine the characteristics of this hazard and argue that it is associated with a special case of asset specificity that we label network specificity, as distinct from the asset specificities included in the Williamson (1985, 1979)

[1]The examination of inter-mediator transactions rather than firms in network externality markets more generally allows us to address the division of labor and to elaborate upon the transactions. The identified asset specificity should also appear in other network markets but, the nature of the inter-firm contracts will be different.