2.3. Organizational economics: the agency and transaction cost theories (Balázs Vaszkun)

Contingency theory, as Donaldson (2001) argues, tends to remain a framework isolated from economics. However, due to its traditional concern with performance, it is or should be consistent with economics. To resolve this contradiction, some attempts have been already made to import elements of economics into organizational theory, mostly using agency theory and transaction costs economics. Without trying to combine all these theories, in this essay we will use the economic approach as a complementary to contingency theory (Vaszkun & Koczkás, 2024) and IBV (Koczkás, 2024). Agency and transaction cost theories introduce the personal interests of managers and do enter more into the black box of organizations, compared to classical economic theories. These theories serve as a foundation for a significant number of IB / IM / CM research projects (Benito et al., 2005; Contractor, 2007; Schwens & Kabst, 2009; Tan & Mahoney, 2003).

2.3.1. The agency theory

Developed mainly from the 1970s, agency theory puts focus on a "contract": a situation with information asymmetry where an owner delegates his rights or power onto somebody else to make the best use of his or her belonging. This owner is called a "principal", and the operator an "agent" (Bowie, 1992). Principals, in order to have their interests better represented, would delegate tasks, decisions and power to the agent, who is supposedly compensated for these services. As a benefit, the principal gains the time, the competencies and the experience of the agent. These gains come with a risk however: the agent may use the property for his or her own benefit. The less information the principal has on the agent's daily activity, the bigger is this risk. Agency theory is mainly concerned by this risk and the incentives which can be used to limit this risk (Eisenhardt, 1989).

In a typical scenario, the parties involved in the relationship could be the employer and employee, or the salesperson and customer. In business, this dynamic is often reflected in the relationship between shareholders or owners and the managers of a company. Traditionally, the primary objective of shareholders is to maximize profits. While this goal is also the managers' formal responsibility, they may have personal objectives that conflict with this aim, such as increasing their own compensation or building a reputation to secure higher positions elsewhere. Even if shareholders (principals) attempt to mitigate risk and exert tighter control over managers, an inherent asymmetry exists: managers always possess more knowledge about their actions than the principals (for example, the extent of the manager's contribution to outcomes compared to external factors or the actual performance of the manager).

This issue has persisted since the separation of ownership and management, and it has become even more complex with the rise of stock markets. Modern corporations now have countless owners, each holding small portions of shares, making it impossible for individual shareholders to effectively monitor management. To address this challenge, they elect trustees or directors to represent their interests to the executive management. However, this creates a twofold risk, involving two contracts and three parties.

"In a corporation, the shareholders elect a group, the board of directors, who in turn, are expected to employ others as managers to oversee day-to-day operations. In theory and legally, the board and these senior managers are agents of the shareholders and are expected to maximize the wealth of these investors. In practice, this is not always the case, raising the vital question of corporate governance."(Wren, 2005, p. 415)

Another significant issue is the board's motivation to genuinely assess the performance of the president and executives, ask probing questions, raise concerns, or undertake other uncomfortable corrective actions. This motivation is often diminished by human nature, conformism, or simply the fact that board members are appointed by the president and are often CEOs of other firms themselves (Angyal, 2001). Agency theory addresses relationships and interactions within any organisation as contracts. However, as contracts are inherently limited when written, they cannot cover every possible scenario. This gap in regulation often leads to the fundamental issue of asymmetrical relationships: opportunism (Williamson, 1985).

Self-interest over collective benefit can be mitigated through performance-based pay (such as stock options), careful selection and socialisation, monitoring workplace behaviour, and more. Corporate governance issues, as highlighted by Wren, include the selection, compensation, and oversight of CEOs by the board of directors. In theory, stock options should resolve the problem of information asymmetry by allowing the market (via stock prices) to evaluate the manager's performance. However, as we will observe from an external (Japanese) perspective, stock options can introduce biases, promoting short-term objectives that may be detrimental to the organisation in the long term.

2.3.2. Transaction costs

Commons (1990) identified transactions as the "smallest unit of analysis in the transfer of property rights." His focus on ownership and the transfer of these rights led him to divide them into two categories: those within the firm and those external to it.

Ronald H. Coase, after studying vertical and horizontal integration in the U.S., revisited the concept of transactions and questioned whether the market (i.e., the price mechanism) could efficiently meet human needs without firms. His inquiry became the foundation for transaction cost theories. Coase (1937) concluded that relying solely on the market mechanism for every production process is less efficient than internalising certain transactions within firms, as monetary exchanges were cheaper than bartering.

Building on Coase's work, Williamson (1996) incorporated concepts such as bounded rationality and opportunism (the pursuit of individual gains in transactions) into his theory of the firm. His goal was to identify institutional solutions that minimise transaction costs.

In transaction cost theory, efficiency is achieved by minimising the use of limited resources in both production and transactions. Production costs are tied to creating products and services, while transaction costs cover the expenses involved in facilitating exchanges. Transaction costs are divided into ex-ante costs, which include contract preparation, and ex-post costs, which involve securing transactions and resolving disputes arising from contract interpretation or contextual changes. Williamson's key contribution was his focus on ex-post transaction costs, as contracts are inherently imperfect and unforeseen problems are inevitable (Kieser, 1995).

Transaction costs can be reduced when agreements and their execution are cost-effective. Three key factors influence these costs: transaction-specific investments, uncertainty, and transaction frequency. Transaction-specific investments may lower production costs but increase opportunity costs if the relationship breaks down, thereby raising transaction costs. This investment binds the parties closer together, but there is hesitance to make such investments without assurance of a long-term relationship.

Thus, transaction costs are generally lower within companies than between independent market players.

Uncertainty, whether related to contextual factors or the behaviour of the other party, can also drive up transaction costs. Monitoring opportunistic behaviour is costly, and uncertainty necessitates protective investments, similar to paying for insurance to avoid larger potential losses. Conversely, frequent transactions reduce costs due to economies of scale, synergies, lower production costs, and a more stable long-term relationship. Williamson (1985) identified three institutional forms for managing transactions: market exchanges, hybrid solutions like long-term contracts (e.g., franchise partnerships), and organisations. The appropriate form depends on the type of transaction; organisations are better suited for reducing uncertainty and opportunism, albeit at higher costs, while markets are more efficient for transactions with low uncertainty and minimal need for specific investments.

In conclusion, transaction cost theory examines contractual relationships with a focus on bounded rationality and opportunism, as opposed to agency theory's emphasis on information asymmetry. Transaction cost theory typically covers ex-post costs, while agency theory addresses ex-ante costs. Neither party in a contract possesses perfect information about transactions or the other's behaviour, which may be opportunistic. Institutions are necessary to control such opportunism and protect the interests of all parties.

2.3.3. Further use of economic theories

The primary focus of these two economic theories in this thesis is not merely the opportunistic tendencies of individual managers, but rather the control systems that must be implemented as a result. Drawing on the work of Jensen and Meckling (1976), Donaldson (1995) criticised agency and transaction cost theories as economic models, as they both assume that individuals within organisations act in their own self-interest, often to the detriment of the organisation as a whole. In agency theory, the agent is seen as misusing the authority and trust granted by the principal, while transaction cost theory suggests that market discipline fails in large corporations, allowing managers to inflate their own compensation. To address this, Williamson (1970) advocated for an M-form organisational structure to limit such opportunistic behaviour and closely oversee the performance of various divisions from the centre.

We observe varying levels of uncertainty, mistrust, and time horizons in Japan and the "Western" economies (e.g.: US), leading to different institutional solutions. In the US, market transactions are more widely accepted and play a greater role, whereas in Japan, production costs are highly valued, and centralised action is better explained by transaction cost theory. Japan's hierarchical approach also provides a different perspective on transaction-specific investments, even in "market" relations. Kester (1996) argued that Japan is more focused on reducing transaction costs and fostering stable relationships, with shareholders often bearing significant agency costs. By contrast, the US prioritises reducing agency costs, formal mechanisms, and commercial relationships, leading to higher transaction costs. As a result, the US, with its shareholder-oriented context, is more concerned with regulating shareholders' interests rather than centralising efforts to lower production costs. Japan, aiming for international competitiveness post-World War II, focuses less on reducing information asymmetry and more on lowering production and transaction costs at a national level. These differences will be explored in more detail in the chapters focusing on regional differences.

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