Understanding Transaction Costs for Your Business

To understand transaction costs for your business, you must first ask yourself why your business exists. Why doesn't market pricing regulate all economic activity? Why isn't each person at every step of production and delivery an independent profit center?

In 1937, Nobel laureate Ronald Coase asked these questions, in which he blamed transaction costs for the contradiction between market agility and a business' stubborn durability. Businesses, in general, incur transaction costs when, instead of using their internal resources, they go to the market for products or services. Transaction costs have three parts, which together, even individually, can be prohibitive.

1. Search costs.

Finding what you need takes time, resources and money. Determining whether to trust a supplier adds more costs. Intermediaries who catalog products and product information could historically reduce such search costs.

2. Contracting costs.

If every exchange requires a unique, separate price negotiation and contract, the costs can be totally out-of-whack with the value of the deal.

3. Coordination costs.

This is the cost of coordinating resources and processes. Changes the arrival of the Internet, it becomes easier for geographically-dispersed businesses to coordinate their activities.

Coase said that companies form to lighten the burden of transaction costs. He then asks another good question: "If company organization cuts transaction costs, why isn't everything one big company?" He answers that the law of diminishing returns applies to company size: big companies are complicated and find it hard to manage resources efficiently. Small companies often do things more cheaply than big ones.

A company will tend to expand until the costs of organizing an extra transaction within the company become equal to the costs of carrying out the same transaction on the open market. As long as it is cheaper to perform a transaction inside your company, keep it there.