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Biographical Notes

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The Buyer's Perspective on Transaction Costs and Relational Norms in the Distribution Channel: Prepositions for Research

by Gunnar Bakkeland and Pierre R. Berthon

Introduction.

Some understanding and form of inter-organisation management is necessary and desirable if a channel is to maintain or achieve satisfactory performance as a competitive entity (Stern and El-Ansary 1992). Although this view is not novel (cf. Alderson 1954, 1957), it has not been the subject of extensive research (Frazier 1983), and interorganisational co-ordination in distribution channels has perhaps received less focus as a survival requirement (Dwyer and Oh 1988) than it deserves. Stern and El-Ansary (1992) seem to reflect traditional points of view when stating that *power* is the major means available to achieve co-ordination and co-operation among channel members. Power, however, gives rise to channel dependence and interdependence issues, (cf. Pfeffer and Salancik 1978; Gaski 1984; Brown, Lusch and Muehling 1983), and issues of interorganisational governance mechanisms which for some years have also interested institutional economists, (cf. Williamson 1993, 1991, 1986, 1981, 1975, Ouchi 1980) and economic sociologists, (cf. Granovetter, 1985, Granovetter and Swedberg 1992). The marketing literature (cf. Heide and John 1992; 1990; 1988) has questioned Williamson's somewhat simplistic treatment of opportunism as an underlying behavioural norm, central as this is to his transaction cost paradigm. Since Heide and John's [1992] work on the role of norms in marketing relationships, there is a distinct possibility that insufficient further research has been done in order to allow comparisons of their findings with those of other studies that differ with regard to cultures, settings, and time periods. Maintaining focus on the transaction between dyadic exchange partners as a fundamental activity in marketing channels (cf. Achrol, Stern, and Reve 1983), the objectives of this article are to examine the existence or otherwise of relational norms between dyadic exchange partners serving as a governance mechanism safeguarding against opportunistic behaviour in the presence of transaction-specific assets. The work of Heide and John [1992] shed much light on this, but examined the dyad from the perspective of a strong buyer facing a large number of small suppliers. We will focus on a strong supplier, facing a large number of small buyers, currently, but not indefinitely, bound to it by legislation and contract. The perspective adopted will be that of many small buyers (pharmacies) from a monopolistic ethical drug wholesaler, at the time of dismantling of a statutory wholesale drug monopoly in Norway.

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Transaction Cost Analysis

Transaction cost analysis, (TCA), refers to the organisation of economic activity "...within and between markets and hierarchies" (Williamson 1975). The theory has been viewed as a "...blend of institutional economics and organisational and legal analysis" (Heide and John 1992), applying concepts borrowed from the economics of law, and economics of industrial organisation (Robins 1987). Common to these views on how TCA works stand the antecedents of Coase (1937) who saw transaction costs (he called them marketing costs) as central to an analysis of the firm, and Commons (1934), who took the same point of departure, emphasising recurrent contracting under conditions of uncertainty. In more recent years, however, the renewed interest in institutional economics is much attributable to Williamson's work (1993; 1991; 1986; 1981; 1975). In his attempt to give a historical review of the events leading to the new institutional economics, he notes that economists' interest in institutions grew strongly in the early 1960s and gained momentum with the contributions from frequently cited authors like Alchian and Demsetz (1972; 1973), Arrow (1969; 1974), Davis and North (1974), Doeringer and Piore (1971), and Nelson and Winter (1982).

Granovetter and Swedberg (1992) have presented an overview of the main reasoning leading to the renewed interest in institutional economics, starting with the proposition that mainstream economics should deal with institutions but does not do so. They state that the missing institutional analysis can be built directly on the basis of the principles of neo-classical economics, and extend the argument by referring back to Williamson (1975) who claimed that the new institutional economics should be seen as complentary to, rather than a substitute for, conventional [economic] analysis. Whilst most new institutional economists agree with the above arguments, Williamson admits that the new institutionalists represent a mixed bag of economists, who apply a heterogeneous approach in their analyses, e.g. economising on transaction costs (Williamson), game theory (Schotter 1981), and efficiency considerations "an institution exists because it is efficient" (North and Thomas, 1973).

Achrol, Reve, and Stern (1983), and Stern and Reve (1980) have made timely contributions by highlighting the fundamental role of transactions in dyadic exchange relationships. Thus, TCA has been used in a variety of settings in marketing specifically: sales organisation decisions (Anderson 1985; John and Weitz 1989), the structuring of distribution channel and purchasing relationships (Dwyer and Oh 1988; Heide and John 1988, 1990; Noordewier, John and Kevin 1990), market entry decisions (Anderson and Coughlan 1987; Klein, Frazier and Roth 1990), expanding the role of marketing in the corporation (Webster 1992), and in other areas of management generally: bureaucracy (Williamson 1979), vertical integration of production (Williamson 1971; Klein, Crawford, and Alchian 1978), clan-like relations within firms (Ouchi 1980), organisational culture (Jones 1983), non-standard contracting, regulation/deregulation and labour-market organisation (Williamson 1986). Yet, a formal definition of TCA applied by a majority of scholars seems difficult to detect, Robins (1987) contends. Some have the virtue of portraying the relationship between transaction costs and market imperfection, e.g., in the latter author's terms, transaction costs are those

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costs associated with an economic exchange that vary, independent of the competitive market price of the goods or services exchanged.

Williamson (1986, 1991) defined transaction costs in Arrow's (1969) terms as the costs of running the economic system, whilst simultaneously portraying transaction costs as the economic equivalent of friction in physical systems. In a rather condensed yet accessible description of transaction-cost economics, Williamson in his 1986 work contends that "...transaction cost economics relies on and develops the following propositions":

1. The transaction is the basic unit of analysis.

2. Any problem that can be posed directly or indirectly as a contracting problem is usefully investigated in transaction-cost economising terms.

3. Transaction-cost economies are realised by assigning transactions (which differ in their attributes) to governance structures (which are the organisational frameworks within which the integrity of a contractual relation is decided) in a discriminating way. Accordingly: (a) the defining attributes of transactions need to be identified; (b) the incentive and adaptive attributes of alternative governance structures need to be described.

4. Although marginal analysis is sometimes employed, implementing transaction-cost economics mainly involves a comparative institutional assessment of discrete institutional alternatives - of which classical market contracting is located at one extreme, centralised, hierarchical organisation is located at the other, and mixed modes of firm and market organisation are located in between.

5. Any attempts to deal seriously with the study of economic organisation must come to terms with the *combined* ramifications of bounded rationality and opportunism in conjunction with a condition of asset specificity. Williamson, in his 1975 work, claimed the principal differences between his approach and earlier literature to be: (1) a concern with tracing out the ramifications of bounded rationality, (2) the notion of opportunism and how opportunistic behaviour is influenced by economic organisation, (3) the notion that market failure is caused neither by small numbers nor uncertainty, but rather by the joining of the two with bounded rationality and opportunism. In his later work, e.g., the 1986 work, Williamson to some extent extended and refined the principal differences, claiming that TCA (1) is more microanalytic, (2) is more self-conscious about its behavioural assumptions, (3) introduces and develops the economic importance of asset specificity, (4) relies more on comparative institutional analysis, (5) regards the business firm as a governance structure rather than a production function; and (6) places greater weight on *ex post* institutions of contract, with special emphasis on private ordering.

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The concept of bounded rationality was defined by Simon (1957) as human behaviour that is "intendedly rational but only limited so". His definition was originally a response to what he saw as unrealistic assumptions of the economic model of decision-making, in which the decision-maker can acquire and retain perfect information, i.e., knows all alternatives and their possible consequences, and seeks to maximise some expected value, (Reitz 1987). Simon (1957) contended that decision-makers are guided by bounded rationality, whereby they are assumed to recognise only a limited number of possible alternatives, and are only limitedly aware of their consequences, (Reitz, 1987). Admittedly, bounded rationality is representative perhaps to merely one approach to the rational system perspective, leaving other systems perspectives aside.

Opportunism in the TCA paradigm is seen as a mode of behaviour that contained "self-interest seeking with guile" and the making of "false and empty, that is, self-disbelieved threats and promises" (Williamson, 1975). Importantly, though not necessarily always brought to attention by writers, Williamson added that "... merely to harbour opportunistic inclinations does not imply that markets are flawed on this account. It is furthermore necessary that a small-numbers condition prevail. Absent this, rivalry among large numbers of bidders will render opportunistic inclinations ineffectual."

Uncertainty and small-numbers exchange relations are seen as environmental factors that lead to prospective market failure (and, hence, internal organisation). Accordingly, such environmental conditions need not impede market exchange, unless joined by the related set of human factors, bounded rationality and opportunism. There seems to be little controversy in the literature about the ramifications of the environmental factors, however.

Information impactedness arises mainly because of uncertainty and opportunism (Williamson 1975) though bounded rationality is involved as well. It exists when true underlying circumstances relevant to the transaction, or related set of transactions, are known to one or more parties but cannot costlessly be discerned by or displayed for others.

The importance of asset specificity was originally set out by Williamson (1971), in his work on vertical integration, and was developed further in his later works (1975, 1985, 1986). In TCA terms, the transaction-specificity of assets yields dependence (Nooteboom, 1993), and becomes crucial when seen together with bounded rationality and opportunism. Nooteboom developed a definition of transaction specificity which means "no alternative use for a given asset", or "no alternative transaction", which seems to be in good accordance with Williamson's reasoning. He also pointed at the need to inspect the relation between asset specificity and the dependence created, the latter mostly assumed to be symmetrical, though not necessarily so. Therefore:

P1 Investments in transaction-specific assets by the small buyers will decrease their control over the monopolistic wholesaler.

Williamson's focus on opportunism has invoked substantial criticism, often by non-economists, e.g., Granovetter (1985), who, according to Williamson himself (1993), in a recent response to some of the critics, approached the study

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of economic organisation by maintaining that "... an understanding of economic organisation resides in studying (96)embeddedness' rather than the governance of contractual relations". Heide and John (1992) summarise the core of the criticism to be one drawing on sociology, arguing that [economic] exchange typically is embedded in social structures in which opportunism is the exception, rather than the rule, as supported by Chisholm, (1989), Granovetter (1985), Shapiro (1987), Martin (1993). Subsequent to Heide and John's (1992) work, Williamson (1993) also saw fit to underline that his view is not that economic agents are engaged in opportunistic practices most of the time. Building on Granovetter's (1985) view, that social embeddedness provides a forceful incentive to limit opportunistic acts, Provan (1993) maintains that "... the opportunistic behaviour of individual network suppliers relative to the dominant buyer, or hub firm, will decline at increasing levels of embeddedness in an independent supplier-buyer network, despite conditions of high asset specificity and small numbers bargaining". Robins (1987) has concluded that transaction cost theory can be a powerful tool for organisational and strategic analysis but that it must be set within the framework of more general organisation theory, and that the weaknesses of the work on transaction costs are not due to inherent flaws in the approach, but stems from an excessively ambitious objective: the attempt to explain the causes or origins of organisational structure.

On Governance Mechanisms, Interdependence, and Norms.

Vertical control has been suggested as a functional substitute for ownership in non-integrated situations although there is no understanding of the conditions that enable a firm to establish vertical control in relationships between independent firms (Heide and John, 1992). Predicting the establishment of vertical control requires an explicit consideration of the conditions that allow control to be relinquished. Heide and John (1992) propose that the presence of certain relational norms at relatively high levels represent such a condition. Yet, norms in marketing have been subject to surprisingly little attention among scholars, although the closely related issue of channel conflict has been studied by many researchers. For example, Gaski (1984) presents an overview of the main theories of power and conflict in marketing channels. The following discusses on a general level why the need for governance mechanisms arises. Then the role of social norms as a possible governance mechanism will be discussed and placed in the context of other possible governance mechanisms.

Governance mechanisms and interdependence

Governance mechanisms are one of the key issues of the TCA paradigm. Williamson (1986) defined governance mechanisms as "...the institutional framework within which the integrity of a transaction is decided". A more precise alternative would be that of Palay (1984): "a shorthand expression for the institutional framework in which contracts are initiated, negotiated, monitored, adapted and terminated". In the TCA paradigm, transactions beween independent companies give rise to costs and different governance mechanisms have different economising properties (Williamson 1985, 1986).

Originally, markets and hierarchies were seen as discrete choices between

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extremes (Williamson 1975), whereas later work presented the same as "main alternatives" (Williamson 1986). Others have extended Williamson's view by treating governance structures as a continuum ranging from spot markets, via short-term contracts, long-term contracts, franchising, joint ventures, to vertical financial ownership (cf. Mahoney 1992, Provan 1993).

Mahoney (1992) in giving an overview of motives for vertical control, has included assuring supplies, and reduction of transfer risk as motives, and identified contracting as an appropriate measure to obtain the desired control. Interestingly, in no case was the existence of norms identified as a source of vertical control. In cases where contracts do not come into application, the question of what is the prevailing form of governance mechanism in a dyad becomes pertinent in light of Stuckey and White's (1993) argument that high levels of specificity, durability and intensity of assets employed in a relationship combined with a high transaction frequency would encourage vertical integration, since transaction costs are likely to be high, and detailed contracts will be difficult to write. Yet, drawing upon Mahoney, vertical integration seems not to be a generally preferred alternative. Furthermore, Heide and John (1992) have argued by building upon Grossman and Hart (1986) that, in situations where complete integration between independent parties is not feasible, (as in the case of a monopolist wholesaler - small buyer dyad), "quasi-integraton" can be achieved by establishing vertical control which, in Grossman and Hart's terminology is not attributable to ownership *per se* but rather to the *ability* to exercise control. This brings forward the issue of inter-organisational dependence, and later also the issue of norms.

The perspective that dependence on vertical trade partners should be avoided has been countered recently by the view that there are advantages to strong ties between firms (Buchanan 1992). According to the author, and based on Porter (1980), El-Ansary and Stern (1972), and Pfeffer and Salancik (1978), dependence traditionally has been seen as a liability, where partners have used their influence to achieve their goals at the other party's expense, thus implying a high degree of conflict and dissatisfaction. Reference to studies by Anderson and Weitz (1989) and Dwyer, Schurr and Oh (1987), support claims that trade partners will realise benefits by establishing long-term relationships and the relational norms needed to govern those relationships. More recently, Heide (1994) has advocated the same view - a shift from market forms of governance and the emergence of vertical marketing systems.

It is important in this context to examine the effect of constraints on this process, however. Both Pfeffer and Salancik (1978) and Buchanan [1992] hold that constraints on behaviour often are considered undesirable, although they also claim that in most cases action is not possible without constraints. Drawing parallels to the TCA paradigm, both information (i.e. information impactedness) and cognitive capacity (i.e. bounded rationality) are important constraints, not only to the process mentioned above, but to the whole issue of governance decisions.

Pfeffer and Salancik (1978) maintain that the context of an organisation is critical for understanding its activities, and that a research focus on internal factors has led to an underestimation of social context and its importance for under-

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standing organisational behaviour. Accepting limitations to cognitive capacity and imperfect decision making also means at least partially accepting a view where "...[an] actor does not entirely control all of the conditions necessary for the achievement of an action or for obtaining the outcome desired from the action". They term this *interdependence.* One should note however that these authors see behavioural interdependence as different from outcome interdependence. Thus, implicitly they introduce the notion of circumstances under which such increased mutual control can take place. This is done by contending that "...social co-ordination of interdependent is possible as a means for managing mutual interdependence. Behaviour in this instance is not determined by hierarchical mandate but by agreements to behave in certain ways. Some of these agreements may be tacit, taking on the characteristics of social norms..." Departing from this, the leap to norms in inter-organisational behaviour is not a large one.

Norms

Several definitions of norms exist, but the one implicitly used by Pfeffer and Salancik (1978) seems to encompass what most researchers agree on: "...Norms are commonly or widely shared sets of behavioural expectations...it is only when most social actors sanction the behaviour that we can say that a norm exist". The work of other authors seems to support this. Gibbs (1981), in particular, has reviewed 14 illustrative definitions of norms from the literature of sociology and social psychology, among them Thibaut and Kelley (1959), and Sherif (1936), to find that, with the exception of Sherif, they seem consistent with his brief statement that "A norm is a belief shared to some extent by members of a social unit as to what conduct *ought to be* in particular situations or circumstances".

Norms may exhibit differences in several respects, applying to different levels, e.g., societies, industries, firms, groups of individuals (Heide and John 1992), and norms have been shown to govern individual exchange relationships between firms Shapiro (1987), Stinchcombe (1986). Further, Pfeffer and Salancik note that norms which have evolved to co-ordinate inter-organisational behaviour are general in content and apply to issues of trust and predictability. Kaufmann and Stern (1988) argue that norms differ in the sense that they manifest themselves differently in discrete transactions compared to exchanges with a highly relational content. According to Noordewier, John and Nevin (1990), discrete exchange norms contain little or no expectation of continuity between exchange partners, whereas transactions with a highly relational content are based on the mutuality of interest, occur over longer periods of time, and are generally "neither sharp in nor sharp out". Much as Pfeffer and Salancik (1978) do, Dwyer, Schurr and Oh (1987) in their discussion of the development of expectations between trade parties see the concept of trust as one major issue deserving priority. Building on MacNeil's (1980) typology of norms, they see relational exchange norms as a dominating type, since, as can be argued, relational exchange dominate over discrete transactions. Thus, the notion of continuity in the exchange relationship, or commitment to exchange as it is described in Stinchcombe's (1986) norms typology, leads to a focus on the relational rather than the discrete norms involved in exchange.

As Bettenhausen and Murrigan (1985) maintain, relying upon Handel (1979),

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norms are specific to the situation and the people who interact within it. This warrants some consideration of exchange behaviour in channels of distribution, as earlier indicated, not the least because expectations and deviations from expected behaviour, the violation of norms, among channel members may form the foundation for conflicts among channel members. Thus, if the validity of the assumption that control should be following naturally from vertical integration is questionable. Considering that investments in specific assets actually may constrain a firm from achieving vertical control because of the dependence that thus is created - what are then the conditions that allow a firm to establish vertical control over another independent firm (in an exchange relationship)? Oppositely, what are the conditions that encourage channel members to relinquish control to others? Combining the views of Heide and John (1992) who claim it is the presence of certain norms that represents such a condition with that of Anand and Stern (1985), who see control relinquishment as a willing and purposeful strategic action, e.g., a non-contractual method of control that provides flexibility and motivates performance, leads to the following proposition:

P2 The small buyer's investment in transaction-specific assets leads to increased control over decisions made by the monopolistic wholesaler for relatively high levels of relational norms.

Power actually may play a role in structuring the relationship of the exchange dyad. Thus, larger buyers (i.e. those subsuming more volume), may be able to exert more control and power over the seller, even if the latter is in a powerful monopoly position. It is proposed that large buyers may acquire more control over decisions by the monopolist wholesaler because in the particular research setting of interest, those buyers are invariably owned by academically well-qualified individuals with considerable social and local political influence.

P3 The larger the buyer, the greater the control over decisions made by the monopolist wholesaler.

Finally, the geographic localisation of the buyers is invariably determined by the government policy in this particular research setting and, thus, the authorities have a strong influence on the severity of competition that a buyer will experience. Spatial competition is minimised, and one will normally find only one buyer in a given rural area, meaning little or no competition in its geographical district. More specifically, this would imply that spatial location would impact on power and control.

P4 The buyer's spatial location will be related to the extent of decision control over the monopolist wholesaler.

P3 and **P4** would account for determinants of buyer control other than transaction-specific assets and relational norms as identified in the literature search.

Finally, a positive interaction between **P1** and **P2** would be expected, that is to say investment in transaction-specific assets by the buyer will be related to the development of relational norms in the dyad. This could be formulated as

P5 Relational norms in the dyad are positively related to the investments in transaction specific assets by the buyer.

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The Model.

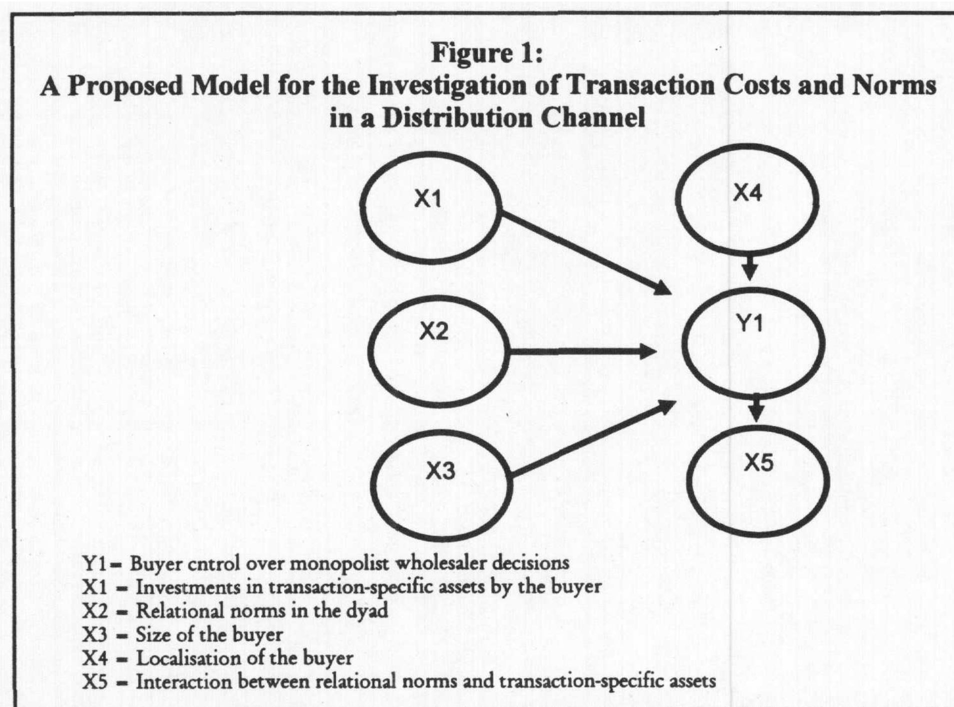
To summarise, the hypothesised relations can be illustrated in the model shown in Figure 1. As can be seen from the model, it is suggested that the criterion variable, the level of buyer control over the decisions of a monopolist supplier (Y1), is affected by the level of investments in transaction-specific assets by the buyer (X1); by the size of the buyer's business in monetary turnover (X2); by the spatial location of the buyer relative to the supplier and other buyers (X3) [termed "localisation"]; and by the interaction between relational norms (X2) and transaction-specific assets (X1), termed X5 in the model. The model has now been stated in testable form, and work is currently under way to gather data to study this.

Conclusions.

Work is currently underway to investigate the presence or otherwise of relational norms serving as a governance mechanism safeguarding against opportunistic actions in a small buyer - monopolist wholesaler exchange dyad. Earlier work in this field has failed to capture dyadic data, in spite of the explicit assumption made about relational norms being bilateral expectations about behaviour, warranting dyadic data. This study intends to improve data collection to allow examination of relational norms *across* the exchange dyad, and it is expected that the particular research setting will give access to such data. Hopefully additional perspectives to the strong-buyer, weak suppliers study of Heide and John (1992) will be provided, in the form of a strong supplier, weak buyers model, in another setting and in another culture.

While this study is to be done in the context of the Norwegian pharmaceutical industry, it is hoped that the results will shed further light on this phenomenon

Figure 1:
A Proposed Model for the Investigation of Transaction Costs and Norms in a Distribution Channel



Y1 - Buyer cntrol over monopolist wholesaler decisions
X1 - Investments in transaction-specific assets by the buyer
X2 - Relational norms in the dyad
X3 - Size of the buyer
X4 - Localisation of the buyer
X5 - Interaction between relational norms and transaction-specific assets

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in other industries in other parts of the world. In many markets and industries, there is still the occurrence of strong supplier-weaker buyer channels. For example, in the United Kingdom, large brewing companies lease, and supply to, so-called "tied houses" - pubs which are obliged to purchase the major portion of their beer stocks from the brewery. In the US, a great number of franchises in industries ranging from fast food to auto repairs face similar, if not identical, patterns. From the practising manager's point of view, the knowledge gained would aid in decisions on governance structures and remind the manager about seeing structure choices more as choices on a continuum, rather as discrete alternatives.

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