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Competitiveness of Economies in the Light of Transaction Cost Theory

Abstract

In the light of the new institutional economics, the most significant pillars of competitiveness among the post-socialist countries are those constituted by institutional requirements that influence transaction costs. Exact transaction costs and institutional conditioning of competitiveness of specific economies can be inferred from the Doing Business reports. The significance of institutional framework as one of competitiveness requirements has been allowed for in the composition of the Global Competitiveness Index (GCI). Analysis of GCI indices relating to the post-socialist countries, it could be concluded here from the new institutional economics perspective, that essential components of the indices methodology obscure the great improvement potential for competitiveness that lies within the institutional area.

1. The Question of Competitiveness with Respect to the Evolution of economic thought

For the last decade the concept of competitiveness has been prevalent in both economics and economic policies. The common view is that competitiveness stands as an indispensable prerequisite for development and improvement, and for maintaining the position of a national economy or a company within the world economy characterized by a constant tightening of relationships between economic entities. Irrespective of how popular the

notion of competitiveness has become, it is still most difficult to define or measure.

We shall attempt to explain the concept of competitiveness by underlining a clear difference between the evidence (indications) of competitiveness and competitiveness requirements first. That an economy is competitive becomes evident when the following three interconnected requirements are met:

- The ability of companies, and, as a consequence, the entire national economy to sell their products in external markets.
- The satisfactory rate of return with regard to business entities engaged in international economic exchange.
- The extent to which local or national resources (human, capital and natural resources) are utilized [Turok 2005, p. 2].

The result of high economic competitiveness is quicker economic growth over the medium to long-term period, and, in consequence, an improved standard of living.

With regard to the above it can be observed that there is a strong link between the question of competitiveness and an economy's effectiveness, and so competitiveness has always attracted much attention from economists. The presence of the concept of competitiveness in the modern world has engendered an attempt to define competitiveness in relation to companies as well as to countries and regions, with the last being considered both in their narrow (a part of a country) and broad senses (citizen states within the European Union). Hence the necessity to define competitiveness as a set of potential conditions for successful development in these times of global tightening of economic and political relationships.

The attempts made so far to define and measure competitiveness have stemmed from the evolution of the theory of growth and development. Despite long lasting efforts in the field of competitiveness made by economists of different schools and ideological orientations, identifying the pillars of competitiveness and thus competitiveness as such, has remained a significant challenge. Over the last few decades the institutional approach to the subject has become more and more influential, resulting in institutions being added to the list of requirements of competitiveness.

While the classical and neoclassical stages of economic theory development emphasized the significance of labour, capital, technology and natural resources, the current approach identified explicit the role and influence of institutions, and thus of culture, the law, politics and history on the one hand, and knowledge on the other. Owing to the renaissance of the institutional perspective in economics, institutions are now counted as the most important

among the nine pillars of productivity and competitiveness. That the institutional approach has earned its place in the mainstream of modern economics should be regarded, on the one hand, as a consequence of excessive difficulties in enhancing the economic performance in former socialist countries and, on the other hand, as a contribution of the new institutional economics (NIE). Considering the orthodox economics, the authors of NIE managed to present their institutional views in a most attractive form. Within this economics the critical role of institutional frameworks has been complemented in an interesting way by transaction costs.

2. Transaction costs as the key concept of the new institutional economics

The concept of transaction costs understood as costs associated with the idea of cooperation and the significance of institutional framework with respect to economy was introduced by Ronald Coase[5] in 1937 [Medema, p. 571; Allen 2000, p. 893; North 1990, p. 12]. Since then, however, it has always given rise to controversy. How to define and measure transaction costs is not exactly clear; the meaning of the concept itself has also remained obscure. For some economists the concept is difficult to specify and its pragmatic aspect unclear, while others see it as revolutionary and important conceptually as "marginalism" [Allen 2000, p. 893]. Moreover, the origin of the notion of transaction costs is considered by many to be arguable. Klaes states that the concept does not originate from heterodox economics, but from theories of money and financial markets, and that transaction costs became the idea that neo-Keynesian literature of the 1950s and 1960s focused on, independently of Coase's work[6]. The prevailing view, however, is that transaction costs

[5] Coase comments on his discovery in the following way: " It was the purpose of my article on "The Nature of the Firm" to provide a rationale for the firm and to indicate what determines the range of activities it undertakes. (…) In order to explain why firms exist and what activities they undertake, I found it necessary to introduce a concept which I termed in that article "the cost of using the price mechanism", the cost of carrying out a transaction by means of an exchange on the open market" or simply "marketing costs". To express the same idea in my article on "The Problem of Social Costs", I used the Phrase "the costs of market transactions". These have come to be known in the economic literature as "transaction costs" [Coase 1990, p. 6].

[6] Klaes points to the association between the concept of transaction costs and, on the one hand, friction in the economic system which became noticeable as early as in the 19th century, and, on the other hand, Hick's investment costs regarded as costs of wealth transfer from one form to another (asset transfer costs). Klaes indicates that Jacob Marshak was the first author ever to use the terms: "cost of transaction" and "transaction costs" directly [Klaes 2001, p. 175]. Marshak

is a concept associated with a critical approach towards fundamental presumptions of orthodox economics and the development of the new institutional economics as an alternative perspective. Speaking in most general terms transaction costs are interpreted as costs of social coordination or as functioning costs of economic system. And since enforcement and transfer of property rights stand as a key issue for social coordination, transaction costs are often regarded as any costs associated with transferring property rights from one party to the other[7].

In his famous article devoted to the origin of a firm and titled *Nature of Firm* Coase came up with two types of transaction costs: costs of hierarchical organization in a firm and market transaction costs. A subsequent analysis of the concept of transaction costs as coordination costs resulted in the identification of political transaction costs. Apart from costs of specific transactions incurred directly by the exchange participants and managerial transaction costs there are also the costs of establishing and maintaining a legal and institutional framework financed with the money from the state budget. Costs incurred in the exercise of legislative, executive and judiciary powers as a result of establishing and maintaining the institutions and political organizations responsible for creating conditions indispensable for social coordination are known as political transaction costs. Thus the costs of legal and institutional functions of the state have been defined in terms of transaction costs. The significance of political transaction costs and the problem of the efficiency of political markets have been outlined by Douglass North [North 1990, pp. 47–52, 99].

Further division of labour has given rise to a number of factors that increase transaction costs [North, Wallis 1982, p. 338]. The number of indirect links has been on the increase, the distance between exchange participants becomes greater and greater, and the time period between placing an order for given goods or services, its completion and payment becomes longer and longer. These factors have increased the risk associated with unexpected difficulties and dishonest contractors. As the goods become more and more diverse, the technological processes become more and more complex, and the degree of interdependence between entities operating in the economic, social and political fields higher and higher, the individual becomes more and more ignorant of this complex reality and the significance of social cooperation grows.

understood these concepts as a broking fee defined as a difference between the price obtained by the seller and the price paid by the buyer [Klaes 2000, pp. 195-197].

[7] In Polish literature an extensive discussion on the idea of transaction costs has been been given by J. Małysz in his article *Instytucje a koszty transakcji w świetle neoinstytucjonalnej ekonomii* (*Institutions and Transaction Costs in the Light of Neoinstitutional Economics*), „Ekonomista” no.3, 2003.

Table 1. Types and examples of transaction costs

Types of transaction costs	Kinds of transaction costs	Examples
Market transaction costs (costs of spontaneous mechanism of cooperation based on competition)	The costs of preparing contracts or search and information costs	Advertising, organizing stock exchange and, fairs, postage and telephone expenses
	The costs of concluding contracts or bargaining and decision costs	Time required for negotiations, costs of legal advice
	The costs of monitoring and enforcing contractual obligations	Costs of measure product quality and amounts, costs of legal services, losses caused by opportunistic behavior of partners
Managerial transaction costs or costs of hierarchical organization in a firm	The costs of setting up, maintaining or changing an organizational design. Fixed transaction costs	Costs of personnel management, investment in informational technology, public relation
	The costs of running an organization; The costs of physical transfer of goods and services in a firm.	Costs of decision making; Monitoring the execusion of orders; Costs of idle time I handling of semifinished products, costs of intrafirm transport
Political transaction costs	The costs of setting up, maintaining and changing formal and informal rules of political organization	Costs of the establishment of the legal framework, the administrative structure, the military, the judiciary
	The costs of running a polity	Current outlays for legislation, defense, the administration of justice, transport and education

Source: Author's research based on Furubotn E. G., Richter R., *Institutions and Economic Theory. The Contribution of the New Institutional Economics,* The University of Michigan Press 2000.

Much as specialization can be profitable, it still involves costs associated with asymmetric relation between the quantity of information every economic entity is dependent on and the quantity of information the entity can obtain. What has been observed over the last few decades is that the division of labour and specialization do not affect all production costs in the same way. While specialization reduces the production costs which functioned only as an object of

economic analyses before the "discovery" of transaction costs, it increases the others. Information and risk minimization become more and more expensive. This is exactly the reason for economists' increased interest in transaction costs and, in the field of economy, the rapidly growing number of occupations associated with exchange costs reduction. Development in banking systems, wholesale and retail markets, insurance companies, legal services, buy-sell agencies, market research companies results from the exchange participants' need to reduce transaction costs, and yet all these professions are examplary cases of devoting resources to exchange processes. The transformation of a society based on personal exchange into a society based on impersonal exchange always increases overall transaction costs, resulting as well in drastic reduction of production costs, which increased exchange costs make up for to an excessive degree.

3. Immeasurable transaction costs and economic competitiveness

Much as the concept of transaction costs enabled economic analysis to cover institutions and paved the way for the new institutional economics, it has ever been an ambiguous idea and one that is most difficult to use in a standard economic analysis. Efforts have been made to fill this concept with a content that would make measuring and application of transaction costs to empirical studies possible but to no avail, having failed to produce any indisputable results. One option is to treat transaction costs as the difference between the price paid by the buyer and the price obtained by the seller. Although this approach has been preferred in the financial markets analysis, the new institutional economics has given relatively little attention to it. North and Wallis were the first economists to make an attempt to measure transaction costs within the new institutional economics. The first step was to identify and separate two sectors in the National Income Accounts: the production sector (farming, industry, mining, construction, transport, services) and the transaction sector (banking, insurance, real estate market, wholesale and retail). According to their estimations the percentage of transaction costs (or transaction services actually, i.e., resources involved in the transaction sector) in the US GNI rose from 26% in 1870 to 54,7% in 1970. A similar tendency has been observed in Australia, where transaction costs, which constituted 32% of the Australian GNI in 1911, rose to 60% in 1991. This strong upward tendency, however, has not been confirmed by the results of the research made on the transaction sector in Argentina, where the shift was of less significance; the transaction sector constituted 25% of the GNI in 1930 and only 28% in 1970. In the following

decade it rose to 35% and no further increase was observed up to 1990 [Wang, p. 4].

This clear difference between the tendency observed in the USA/Australia and Argentina can be derived not only from disparate economies, but from the very problems that arise in measuring transaction costs as well. The transaction sector that North and Wallis used as a basis for the evaluation of transaction costs does not cover all transaction costs generated by an economic system. The transaction sector covers only these costs which are produced by the market and reflected in official figures, whereas exchange processes are associated with costs not accounted for in official statistics. And these comprise both time and expenditures spent on acquiring data concerning the quality and prices of products available, and losses associated with legal procedures indispensable for carrying out business activity, i.e., all costs that result from excessive regulations and bad legislation, as well as a lack of competence and dishonesty in the field of politics and bureaucracy. These losses are not reflected as costs in the firm's official profit and loss account, although they reduce production significantly. Waiting for an administrative decision or meeting bureaucratic requirements is time-consuming and, as an effect, equal to hindering the production or devoting resources to non-production activities. Such transaction costs may reach a very high level in the economies of developing countries and countries undergoing transformation, despite the official level of the transaction sector, of which Argentina is a good example.

The problem of transaction costs not accounted for directly in gross national income directly has been addressed by Hernando de Soto, who focused on the extremely high costs of carrying out business activity in such countries as Peru, Egypt, the Philippines. These high costs resulted from the necessity of meeting local administrative requirements. De Soto noticed that registering a company may take up to 289 days, and purchasing the smallest land plot involves the completion of 728 formalities. [Soto 2002, p. 39]. As a result of the *Doing Business* project, a research program conducted by the World Bank, more and more data concerning institutional conditions for carrying out business activity is generated today. As the annual reports say, there is a great diversity of legal conditions and regulations that govern the establishment and maintenance of business activity. The sheer number of procedures related to establishing a business, exercising property rights and respecting agreements and government regulations of all sorts can be regarded as the source of high transaction costs. Unstable political condition, inefficient bureaucracy, corruption and crime are all indicative of the lack of institutions that would guide social coordination. In addition, they are all responsible for the waste of resource and generation of costs that can be counted as transaction costs. Some of these costs, if not the vast

majority, can be regarded as non-market costs, not reflected in any official figures.

Table 2. Conditions for carrying out business activity in 2006

Ease of doing business (rank)	Economy	Starting a business		Registering property		Enforcing contracts	
		Procedures (number)	Time (days)	Procedures (number)	Time (days)	Procedures (number)	Time (days)
1	Singapore	6	6	3	9	29	120
2	New Zealand	2	12	2	2	28	109
3	United States	5	5	4	12	17	300
4	Canada	2	3	6	10	17	346
5	Hong Kong	5	11	5	54	16	211
16	Lithuania	7	26	3	3	24	166
36	Slovak Republic	9	25	3	17	27	565
75	Poland	10	31	6	197	41	980
96	Russian Federation	7	28	6	52	31	178
147	Uzbekistan	8	29	12	97	35	195

Source: *Doing Business* 2007. *How to Reform,* World Bank and the International Finance Corporation, Washington 2006, s. 80–85, 92–94.

Table 2 shows selected conditions for carrying out business activity in Poland in comparison with top five countries on the *Doing Business* list and selected post-socialist countries. Procedures associated with establishing business activity, with property registration and court proceedings concerning violation of contract terms are burdensome and time-consuming, not only when compared to countries with highly competitive economies such as Singapore, but also to those that have achieved a similar stage of economic development. Table 3. shows unfavourable conditions for business activity leading to higher transaction costs, which in turn affects in a negative way the competitiveness of economies undergoing dynamic transformation. According to businessmen, unstable political condition, distrust towards the judicial system, corruption, crime and high tax rates impose greatest restraints on business activity.

Table 3. Investment climate*

	Policy uncertainty	Corruption	Lack confidance courts uphold property rights	Crime	Tax rates	Labour regulations
China	32,9	27,9	17,5	20,0	36,8	20,7
Czech Republic	20,2	12,5	47,1	14,3	25,6	3,5
Hungary	21,1	8,8	40,3	4,9	30,2	7,3
Lithuania	33,5	15,6	59,5	16,2	10,0	8,5
Peru	71,1	59,6	34,7	51,6	...	...
Poland	59,1	27,6	46,2	24,9	64,7	25,2
Russian Federation	31,5	13,7	65,3	12,4	24,4	3,3
Slovak Republic	44,6	27,5	53,9	15,4	31,7	7,4
Uzbekistan	27,2	8,7	25,4	7,0	19,9	1,7

*The table shows % of senior managers who regarded the factor given as a major or very severe constraint

Source: *2005 World Development Indicator,* The World Bank, Washington, pp. 274–277.

On reading the reports made within the *Doing Business* project, one might be tempted to assume that as far as the underdeveloped countries are concerned, high transaction costs, typically non-market ones, constitute the main obstacle to growth. Generally speaking, in poor countries the procedures involved in establishing business activity and in employment and property registration are complicated and expensive. It turn out that in poor countries the contract-exercise costs are three times higher than in rich ones, and that it is complicated and onerous legal procedures that to a great extent should be blamed for low business activity, lack of capital, and the growth of the informal economy. It has been estimated that should improvement of conditions for carrying out business activity be made in the countries where these conditions are most severe, the economic growth rate could be increased by 2.2 percentage point there [*Doing Business* 2005, p. 4], which would lead to the conclusion that legal conditions

for establishing business activity constitute a key element of competitiveness, as of yet underestimated by politicians.

4. Global Competitiveness Index (GCI) in relation to transaction costs

Synthetic reports on competitiveness of national economies have been released by the *World Economic Forum* since 1979. With a view to providing politicians and businessmen with the most accurate instruments possible for institutional reforms and economic policies, the methodology for creating competitiveness indices have undergone many changes. In the most recent *Global Competitiveness Report 2006-2007* the world competitiveness ranking has been made in accordance to the GCI. The composition of the index is based on the assumption that the competitiveness of a national economy is constituted by a set of factors, institutions and policies defining the country's production level over the medium to long-term period [GCR 2006-2007, p. 3]. The GCI is based on nine pillars divided into three primary groups related to three sub-indices (table 4.). Weighted average of sub-indices is tantamount to the synthetic GCI. The weights depend on particular stages of economic development (table 5).

The methodology for creating global competitiveness indices has been clearly influenced by the new institutional economics and the concept of transaction costs, although some of the most basic methodological assumptions are prone to criticism from the institutional perspective. Institutions are regarded as the first of nine pillars of competitiveness. Criteria used by the GCI to assess the effectiveness of institutions[8] reflect those elements of institutional background that have the greatest impact on the quality of social cooperation, and transaction costs as an effect. The assumed multiplicity and complementarity of competitiveness factors, as well as the assumption saying that the significance of particular factors changes at each stage of economic development remain in accordance with the institutional approach.

[8] To assess the effectiveness of public institutions, the GCI uses five criteria: respect for property rights, ethics of government behavior and the prevalence of corruption, independence of judiciary, government inefficiency in the waste of public resources and heavy regulatory burden and ability to provide adequate levels of public safety for economic activity [*Global Competitiveness Report 2006-2007*, *Executive Summary*, p. 6].

Table 4. Composition of *Global Competitiveness Index* (GCI): subindexes and pillars of competitiveness for three stages of development

Subindexes	Pillars of competiveness	Key for
Basic requirements	1. Institutions 2. Infrastructure 3. Macroeconomy 4. Health and Primary Education	1st stage of development: factor-driven economies
Efficiency enhancers	5. Higher education and training 6. Market efficiency 7. Technological readiness	2nd stage of development: efficiency-driven economies
Innovation and Sophistication Factors	8. Business sophistication 9. Innovation	3rd stage of development: innovation-driven economies

Source: Author's research based on *Global Competitiveness Report 2006–2007*, Part 1, p. 12.

Table 5. Composition of *Global Competitiveness Index* (GCI): weighting of subindexes at each stage of development

	Basic requirements	Efficiency enhancers	Innovation and sophistication factors
Factor-driven stage GDP per capita < 2000USD	50	40	10
Efficiency-driven stage GDP per capita od 3000 do 9000 USD	40	50	10
Innovation-driven stage GDP per capita > 17000 USD	30	40	30

Source: Author's research based on *Global Competitiveness Report 2006-2007*, Part 1, p. 12.

From the perspective of transaction costs economics, however, it is unjustified to use GNI *per capita* as the only criterion for deciding which of the three stages of economic development a given country has achieved. Furthermore, the weights relating to sub-indices are arbitrary and do not allow for individual characteristics of a given country. These methodological flaws are revealed in the process of analysis of indices ascribed to the countries undergoing transformation. Most of them have been ranked as countries at the first and second stage of development, three (the Czech Republic, Estonia and

Hungary) as countries at the intermediate stage (between the second and third stage), and one country, Slovenia, has been ranked as the country at the third stage of development. Not only does such an automatic division ignore the

Table 6. Global Competitiveness Index: rank, scores and sub-indices in some of the former socialist states

Overall GCI		Economy	Sub-indices GCI (scores)			
			Basic requirements		Efficiency enhancers	Innovation and Sophistication Factors
Rank	Scores		Overall	Institutions		
25	5,12	Estonia	5,31	4,70	5,18	4,24
29	4,74	Czech Republic	4,89	3,84	4,73	4,47
33	4,64	Slovenia	5,17	4,27	4,58	4,18
36	4,57	Latvia	4,90	4,07	4,48	3,74
37	4,55	Slovak Republic	4,70	4,03	4,56	3,96
40	4,53	Lithuania	4,80	3,86	4,44	3,96
41	4,52	Hungaria	4,64	4,18	4,57	4,08
48	4,30	Poland	4,59	3,62	4,17	3,80
51	4,26	Croatia	4,60	3,72	4,07	3,81
54	4,24	China	4,80	3,51	3,66	3,75
56	4,19	Kazakhstan	4,64	3,59	3,97	3,51
62	4,08	Russian Federation	4,43	2,97	3,91	3,55

Source: *Global Competitiveness Report 2006–2007. Executive Summary*, p. XVIII–XIX.

differences between countries ranked as being at the same stage of development that are essential from the institutional point of view, but it also disregards a feature of great importance that is common to all countries undergoing transformation, i.e., their immature institutional arrangements for securing the country's economy. Although the countries differ significantly in terms of the degree to which their institutional frameworks are immature, the juxtaposition of sub-indices shows clearly that the marks given for the institutional background

were lowest, an assessment which remains in accordance with the presupposition stating that with respect to the post-socialist countries, the main obstacle to growth is derived from the political culture and lifestyle, both inherited from the previous system. These two elements curb the development of regulations that would instigate growth in business activity both in the public and private sector. As it can be inferred from table 4, in countries undergoing transformation the sub-indices relating to basic requirements are always higher than the remaining ones, notwithstanding the institutions, taken as components of basic requirements, scoring lower than those components whose significance grows, according to the GCI methodology, with every stage of development. With regard to the post-socialist countries, this implies a great potential for improving competitiveness in the institutional area. Due to this institutional gap even those countries which, having completed reforms in the fields of macroeconomy and economic liberalization, improved their world ranking at first, have slowed down in terms of positive transformation process. Poland could be taken as an example here. Much as Poland was regarded among countries undergoing transformation as the leader in the area of economic changes in 1996–1997, its situation has been degrading slowly ever since. The GCI ranking indicates that in 2006 Poland (ranked 48) outscored only the newest European Union members: Romania (68) and Bulgaria (72). It is worth noticing though that these two countries are ranked higher in the ranking made on the basis of the *Doing Business* project.

It has been stated by the authors of the *Global Competitiveness Report 2006–2007* that the weaknesses of Polish economy result primarily from the institutional arrangements responsible for the inflexibility of the labour market, for insufficient security of property rights and its inefficient judicial system, all of which provoke corruption and crime. “Deeper reforms will be necessary if Poland is to increase productivity and stay competitive in the face of rising labor costs. However, instead focusing on competitiveness-enhacing reforms, the government has more recently reverted to ill-conceived interventions while aere undermining the business environment and creating a climate of macroeconomic vulnerability”[9, p. 31]. As examples of improper measures, convoking a government-controlled Financial Supervisory Commission and incessant effort to invade the independence of the Polish Central Bank have been given.

5. Conclusion

The transaction costs economics enables the institutional perspective to be widely used in analyzing of economic conditions. Thus the concept of transaction costs as costs resulting from the division of labour and the quality of social cooperation could have a great influence on how the problem of competitiveness of national economies might be interpreted. The *Doing Business* and *Global Competitiveness* reports are based on the assumption that institutional reforms have a specific impact on national economy growth; this assumption has been confirmed by the research results. It is nevertheless true that difficulties in imparting quantitative dimension to institutions and transaction costs could make the procedures applied prone to criticism and can be viewed as inconsistency within the institutional approach.

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