Transaction Cost Theory

- Should you manufacture in-house or outsource the work?
- The transaction cost theory refers to the cost of providing for some good or service through the market rather than having it provided from within the firm.
    - It is a theory accounting for the actual costs of outsourcing production (the cost involved in making an exchange).
    - It helps determine when activities would occur within the market and when they would occur within the firm.
- Transactions are transfers of goods and services across interfaces.
- When transaction costs are high, internalizing the transaction within the firm was a better decision, and when costs were low, buying the good or service in the market was better.
- Transaction costs are search and information costs, bargaining and decision costs, and policing and enforcement costs.
    - Search and information costs are costs such as market research and cost analysis.
    - Bargaining and decision costs are costs such as contract costs and bargaining costs.
    - Policing and enforcement costs are costs such as making sure the other party sticks to the contract.
- Without taking into account transaction costs, it is impossible to understand economic systems and establish business plans or economic policy.

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