

LEGAL UNDERSTANDING OF TRANSACTION COSTS

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Abstract

Purposes: This paper is devoted to the legal understanding of transaction costs both as a concept and a method developed within the framework of the institutional economics discipline for analyzing the consequences of various kinds arising from the exchange of goods. This work is relevant due to the need to apply new interdisciplinary methodological approaches to solving the problems that classical jurisprudence faces. The authors gave legalized concepts of transaction and transaction costs.

Methods: As the main task within the framework of this paper, the authors proposed a classification of transaction costs, with the help of which it is possible to analyze legal activity in various fields. The study was based on the works of foreign and Russian scientists, economists and lawyers.

Results: In the paper, the authors found that the classification of transaction costs used in economics was created only for analyzing relationships within substantive law and using them to analyze other legal relationships seems to be quite problematic. As a result of the study, the authors developed a new classification of transaction costs, which can be used both for the analysis of substantive and procedural law. Also, they focus on certain aspects of various transaction costs.

Implications/Applications: In this regard, a problem arises in creating a classification that would take into account the advantages of all these approaches, and would also be suitable for describing both substantive and procedural legal relations.

Novelty/Originality: The development of domestic and foreign legal science is impossible without the use of interdisciplinary approaches, including not only the interaction of intersectoral relations, and this article has studied this issue.

Keywords: *Transaction Costs, Theory of Law, the methodology of Law, Economic Analysis of Law, Institutional Economics, Effectiveness of Law.*

INTRODUCTION

Modern fundamental jurisprudence which is based on the study of law as an open, dynamically developing and the self-organizing system pays great attention to the latest methodological approaches to the information on the essential characteristics and interaction between legal relations with other institutions. One of the most important of them is economics. Such heteronomous, at first glance, formations like law and economics, at the general theoretical level may well be combined into a single scientific interdisciplinary space being an integrative, interacting and interdependent construction.

Upon that, if we use the methodology of legal science to analyze economic relations, the result will be an “economic law”. On the contrary, if we agree with J. S. Mill that economics is not so much a science as practice; the result will be an economic analysis of law ([Mill, 1967](#)).

As noted, economics and various types of economic activity, being a priori regulated by legal mechanisms, techniques, methods of ordering and regulation through the normative sphere, are, at the same time, independent interdisciplinary socio-humanitarian spheres of knowledge.

As justifiably noted by V. V. Ershov, E. M. Ashmarina, and V. N. Korneev, a “complex mega-branch” of economic law has been formed in modern Russia. It is historically conditioned by the close interaction of economics and law, takes into account and is presented by the streamlining of public and private interests in the process of “progressive change of the stages of economic activity (exchange, distribution, production and consumption)”. The significance of these processes for the world community and national interests in substantiating the doctrine of economic law makes it possible to state the need to divide the mega branch of the economic law into private and public economic law in two different directions: macroeconomics and microeconomics. Their study should be based on formally dogmatic, comparative and other approaches, including the use of new methods of economic theory. One of them is the method of “transaction costs”, by extrapolating which into the sphere of legal science it is possible to reveal the effectiveness of certain regulatory provisions in the economic and legal sphere of activity ([Ershov et al., 2016](#)).

METHODS

Within the framework of such a discipline as an economic analysis of law, there are several approaches to measuring the effectiveness of the law, which are taken primarily from economics:

1. Allocative efficiency which determines the effectiveness of a one-time redistribution of resources between participants in market relations in the short term;
2. Pareto efficiency which determines the exchange as effective, if during a redistribution of resources some participants receive benefits in the exchange, while others do not lose their benefits;
3. Kaldor-Hicks efficiency which determines the exchange as effective if, during the redistribution of resources, participants of an exchange who lose resources, lose them less than other participants in the exchange receive them;
4. Dynamic efficiency focusing on the long-term effects of redistribution of resources.

These types of efficiency aim to allocate resources that would maximize public goods: cash, lack of crime, compliance with contractual obligations, and others. At the same time, the “legal reality” concept prompts us that the legal discourse redistributes not resources, but rights, freedoms, duties and competencies, and guarantees. However, even such material benefits are transferred from some entities to another, taking into account certain obstacles, or “transaction costs”.

The concept of transaction costs directly follows from the concept of the transaction (or deal). For example, American economist John Commons writes, “A transaction is not an exchange of goods, but alienation and appropriation of property rights and freedoms created by society” ([Commons, 1931](#)). Karl Polanyi believes that transactions are social and economic interactions ([Polanyi, 2001](#)). At the same time, the Finnish economist Petri Ollila argues that a transaction is a legal transfer of ownership ([Ollila, 2009](#)). These three approaches demonstrate a different level of abstraction when attempting to define a transaction. If the statement of Mr. Polanyi can be considered too vague, the concept given by Mr. Ollila and Mr. Commons narrows the scope of application of economic methodology only to the issues of ownership, while this method can be successfully used in analyzing the norms of various branches of law. It is also worth noting that in institutional economics and economic analysis of law, one of the main areas of research was the study of property rights. In this regard, for the application of this methodology, for example, in the procedural relation analysis, it is necessary to expand the object of study. It is possible to formulate a definition of a transaction as follows: “**A transaction is the alienation and appropriation of rights, obligations, freedoms, guarantees, responsibility and competence between participants of legal relations**”.

The next issue is the definition of transaction costs. Thus, an American economist Kenneth Arrow defines transaction costs as the costs of operating an economic system ([Arrow, 1985](#)). Another well-known economist, Douglas North, did not define transaction costs but wrote that they “consist of the costs of assessing the useful properties of an object of exchange and the costs of securing rights and forcing them to comply” ([North & North, 1992](#)). As a definition of transaction costs, it can be proposed to describe them as “**the loss of materials, time or energy necessary for conducting a transaction**”.

Speaking about the classification of transaction costs, it is worth mentioning that there are several models of this classification. In this work, a model created by American researchers (the North-Eggerson model), as well as two models proposed by Russian scientists, A. A. Auzan and M. Yu. Malkova was used as the sample models.

In accordance with the North-Eggerson classification ([Eggertsson et al., 1990](#)), transaction costs are formed from the following actions: 1. search for information about counterparty; 2. negotiation; 3. drafting a contract; 4. monitoring contract performance; 5. enforcement of a contract; 6. protection from third parties.

In accordance with the classification by A. A. Auzan, transaction costs consist of the following components ([Auzan, 2017](#)): 1. search for information; 2. negotiation; 3. measurement of the good (subject of the contract); 4. specification and protection of property rights; 5. costs of opportunistic (or, in a more customary interpretation to lawyers, unlawful) behavior; 6. management/decision making. In our opinion, the elements of this classification need clarification. The specification of rights (not necessarily property rights) means the definition of ownership of the rights by participants in legal relations. In the absence of a specification of rights, problems arise when choosing the appropriate defendant. Opportunistic behavior can be defined as the behavior of an individual who seeks to obtain a one-sided benefit at the expense of his/her partner, evading compliance with the terms of the contract ([Odintsova, 2007](#)). The costs of opportunistic behavior are the costs of controlling compliance with the terms of the contract, representing certain risks, both economic and legal, for other parties to the contractual relationship.

The third classification under consideration was developed by M. Yu. Malkina. In accordance with this classification, transaction costs consist of the following elements: 1. information retrieval; 2. negotiations; 3. measurement of attributes (characteristics) of the good; 4. conclusion of a contract; 5. making payments; 6. specification and protection of property rights; 7. expenses for opportunistic behavior. Also in this classification, the listed costs can be divided into two parts: ex-ante (before the conclusion of the transaction) and ex-post (after the conclusion of the transaction). The first group includes the first four types of costs and the second the remaining three types ([Malkina et al., 2015](#)).

RESULTS AND DISCUSSION

As can be seen from the examples above, there are types of costs for which there is a complete consensus among scientists: the costs of finding information and the costs of negotiating. There are those that are present in two

classifications, but there are those that are inherent in only one. These facts suggest that none of the classifications is universal, and all of them classify only transaction costs associated with the transfer of ownership, while the list of objects of transactions in legal reality seems to be wider.

First of all, it is necessary to divide the transaction costs into several parts:

1. Before the conclusion of a transaction;
2. During the execution of a transaction;
3. In the case of non-execution of the transaction;
4. Present at all stages of economic and legal activities.

In this approach, when allocating at the second stage, it is focused on the fact that the obligations under the contract are not always executed simultaneously, but may take a long time.

Next, we will describe the steps to change the existing classifications in order to create a new classification that reflects the main features of legal reality. If necessary, in brackets we give legalized examples of transaction costs.

The costs of finding information can be divided into two of its component parts: 1. search for information about the counterparty and the specification of rights (the establishment of a proper defendant in a legal process); 2. measurement of the attributes and quality of the good (checking the purchased property for collateral).

The costs of opportunistic behavior can be expressed in four basic forms. The first two of them are aimed at preventing opportunistic behavior, the second two take place after committing an act of opportunistic behavior.

1. Increase in the costs of drawing up a contract in order to provide for the opportunistic behavior of the counterparty and ways to minimize it;
2. Increase the cost of monitoring and controlling the execution of a transaction or insurance;
3. Protection of rights after their violation;
4. Direct economic losses.

The costs of making payments can be understood more broadly than just paying for goods, works, and services. Making payments can be called a value exchange. In this case, this activity will be the main content of the transaction. In particular, when concluding a real estate purchase and sale agreement, making payments will include not only payment of the seller's value by the buyer, but also the costs of the necessary registration activities associated with fixing the transfer of ownership in the state register.

In addition, it makes sense to combine in one clause activities to protect the rights and forcing the other party to fulfill obligations, since the two actions correlate as part and whole because enforcement of obligations is one of the parts of the broader concept of rights protection.

Therefore, our integrated transaction costs model will look like this:

I. Transaction costs before the conclusion of the transaction:

1. Cost of finding information:
 - a) Search for information about the counterparty and specification of rights;
 - b) Measurement of attributes and qualities of the good;
2. Costs of negotiations;
3. Costs of drawing up the contract (there are also costs of opportunistic behavior);
4. Costs of entering into an agreement;

II. Transaction costs during the execution of the transaction:

5. Costs of the exchange of values;
6. Costs of monitoring and control (there are also costs of opportunistic behavior);

III. Transaction costs in case of non-execution of a transaction:

7. Costs of opportunistic behavior (direct losses);
8. Costs of rights protection (there are also costs of opportunistic behavior);

IV. Transaction costs those are present at all stages:

9. Management and / or decision-making costs;

10. Costs of protecting rights from third parties.

It is also worth noting that transaction costs can be divided into 1) natural - that is, arising without the participation of a state (government), and 2) closely associated with government regulation. For example, in the case of entering into an employment contract with a foreign citizen or a stateless person, the natural transaction costs at the contract conclusion stage will be only the costs of signing the contract by two parties. State-based transaction costs will be transaction costs for obtaining work permits for a foreign citizen, notifying the migration authorities of the employment contract, etc. We should also pay attention to the fact that the process of protection of violated rights (for example, the resolution of a dispute in court) can also be considered a transaction, which will consist of these steps.

SUMMARY

Thus, the transaction costs method, being created for a legal analysis of the distribution of values at the level of property law, requires significant adjustment. The reason is in connection with its use in monitoring various manifestations of legal reality arising in various branches of law. The first step in the implementation of this task is the selection of a suitable classification of transaction costs, which in the future can be used to analyze costs manifested in economic and legal activities, as well as to find ways to minimize these costs.

CONCLUSIONS

In conclusion, it is worth noting that the development of domestic and foreign legal science is impossible without the use of interdisciplinary approaches, including not only the interaction of intersectoral relations (Chelyshev, 2002) but also the synergy (interaction) of legal, economic, political, psychological and natural-humanitarian areas (Stepanenko, 2015). In this regard, it appears that economic theory, as well as the practical field of institutional economics, will propose an effective methodology for responding to various modern legal problems. At the same time, the use of these methodological approaches is impossible without their deep understanding and their adaptation to the realities of domestic and foreign law and economics.

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