The article analyzes the challenge faced by the transactional theory of the firm in connection with the domination of business groups being specific organizational forms in the economies of developing countries. In response to this challenge we propose to expand the research subject of the transactional theory of the firm and thus include internalized political resource owners in the analysis. Under this approach firm owners are either financial capital owners or internalized political resource owners. This depends on the parameters of the institutional environment. In the first case a firm exists in the form of a public corporation, while the second one is represented by a business group.

Keywords: transactional theory of the firm, business groups, political market, internalization of political resource.

The article was supported by RFBR grant № 12-06-00290 «The specificity of the political recourse of Russian entrepreneurs and its impact on innovational development” (2012-2013).

In modern economic science the transactional theory of the firm as a part of the new institutional economics has become a leading approach in explaining the reasons of a firm’s existence and development. Its formation and development is one of the most important advances in the economic theory of the XX century. The starting point of both the transactional theory of the firm and the new institutional economics is considered to be Coase’s famous paper "The Nature of the Firm" published in 1937. During the XX century the transactional theory of the firm took significant steps in its development and became one of the most important parts of modern economic mainstream.

It is important to note that all theoretical approaches to the nature of firms seek to answer fundamental questions first formulated by Coase (Coase, 1937):

1. The existence: why do firms exist? Why aren’t all the exchanges in the economy done through the market mechanism?
2. Boundaries: What determines the boundaries of a firm?
3. Organization: Why do firms have such a structure? How do formal and informal structures interact?

Parallel development of various theories of the firm is to a large extent explained by their different approaches to the concept of “a firm”
and various research objects. As Tambovtsev stated “various theories of the firm highlight ... different aspects, elements and interactions between them, build various models of the firm that results in non-identity of objects of these theories” (Tambovtsev, 2010).

In the framework of different theoretical approaches a firm can be represented as:

- a production unit – the neoclassical approach;
- a decision making process – the behavioral theory of the firm;
- a contract decision – the transactional approach.

In the framework of the neoclassical approach a firm is understood as a production unit supplying the market with products and services. It is described as having a production function and perceived as a “black box” that transforms inputs into products and services. In contrast to neoclassical economics, organization theorists seek to explain the processes in a firm, as well as its relationships with the environment. From the perspective of this approach (the behavioral theory of the firm) the coordination of individual units and individuals is a key function of a firm. Effective coordination is not automatic; it is determined by the executives’ decisions which determine an organization’s structure, control mechanisms, incentives, goals and members. Therefore, the study of how managers make decisions is crucial for the analysis of an organization and its actual behavior (Table 1).

Simon, a classic of the organization theory, identified an organization as “a pattern of communications and relations in a group of human beings, including the processes of making and implementing decisions” (Simon, 1997). Cyert and March describe an organization as “a decision-making process” (Cyert and March, 1992). Scholars have noticed that profit maximization is not the most important goal that drives managers’ decisions as it is implied by the neoclassical theory of the firm. Managers are guided by conflicting goals and have bounded rationality.

Both neoclassical and behavioral theories of the firm have a significant influence on the economic theory development, but the dominant position is currently held by the transactional approach.

According to the transactional theory a firm is regarded as an extreme single grading scale of coordination mechanisms that differ

<table>
<thead>
<tr>
<th>Theory of the firm</th>
<th>Definition</th>
<th>Role</th>
<th>Scope</th>
<th>Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Neoclassical</td>
<td>Production function</td>
<td>Supply of products and services</td>
<td>Technology</td>
<td>Production costs and market power</td>
</tr>
<tr>
<td>Behavioral</td>
<td>Decision-making process leading to action</td>
<td>Coordination of specialized units through information processing</td>
<td>Rationally bounded decisions of management coalitions</td>
<td>Effectiveness of internal structure to deal with the environment</td>
</tr>
<tr>
<td>Contracting</td>
<td>Nexus of contracts</td>
<td>Governance structure of transactions (vs. markets)</td>
<td>Transaction costs</td>
<td>Total costs, especially transaction and agency costs</td>
</tr>
</tbody>
</table>

from another scale – the market – in the type of a dominant contract. If the market is dominated by classical and neoclassical contracts, a firm is ruled by a relational contract of employment. The key concept of the transactional theory of the firm is transaction costs. The concept of transaction costs was introduced by Coase who answered the question why firms exist in the economy (Coase 1937). His response was that the exchange can be carried out both inside an organization and outside it through the market mechanism. Applying the traditional principle of optimization, firms internalize those exchanges, the implementation cost of which is lower in a firm.

Research approaches, rooted in Ronald Coase’s works, can be divided into two groups: 1) the theory of property rights (Jensen, Meckling, 1976) and 2) the agency theory (Fama, 1980) and Williamson’s transaction cost economics (Williamson, 1985) which came into existence on its basis.

The theory of property rights emphasizes the rights in an organization established by contract. A firm is regarded as “a legal fiction” which is a nexus of contracts on the factors of production. According to the classical theory an agent who personifies a firm is an entrepreneur who is also a manager and a residual risk bearer. This approach is unable to explain a large modern corporation in which the control of a firm is in the hands of managers who are separate from shareholders. The situation changed with the formation of the agency theory which models a modern corporation as a structure that separates two key functions of an entrepreneur – management and risk-taking. Thus, the separation of ownership and control is an effective form of economic organization within the concept of “nexus of contracts” (Fama, 1980).

Another branch of the transactional theory of the firm is Williamson’s transaction cost economics. The approach is interdisciplinary; it includes concepts from economics, law and the organization theory. Williamson often uses the term “hierarchy” describing a firm as a transaction control mechanism and emphasizing the relationship of subordination in an organization. In fact, an organization’s members do not appeal to the courts to resolve disputes but turn to a higher position in the hierarchy.

Williamson’s most important contribution to the transactional theory of the firm is probably his analysis of why and under what circumstances higher transaction costs can be expected, and namely whether it is the market mechanism or the hierarchy. Williamson attributed managers’ declining attention to new activities, bureaucratic delays and other costs as well as the use of hierarchical forms of coordination to the management (bureaucracy) cost. A firm internalizes those transactions that can be managed more effectively within a hierarchy than through market exchanges, i.e. when market transaction costs are higher than bureaucratic costs of managing these transactions in a firm.

Thus, the hierarchy is a response to various types of market failures which can be explained by higher market transaction costs. For example, vertical integration is the result of market failure in the market of intermediate goods and labor market. In contrast, multidivisional structure can be considered as a substitute for institutional failure in the capital market and may contribute to an unrelated diversification.

According to Williamson (1985) the most common market failures are:

1. Bounded rationality and environmental uncertainty. As Simon claimed, “human behavior is extendedly rational, but only boundedly so” (Simon, 1955). The information processing capability of humans is limited and the complexity of our uncertain environment is so large
that it is impossible to fully optimize every decision. This places a limit in the possibility to write full contracts that could otherwise regulate all relations between independent actors. Complex transactions surrounded by greater uncertainty will tend to be internalized in a firm.

2. Opportunism, defined by Williamson as self-seeking behavior with guile. Some people may behave opportunistically if they have a chance, which is given by a contract with some gaps. Firms essentially emerge to overcome the situations in which the threat of opportunism is particularly large and damaging to at least one of the parties.

3. Asset specificity. Investing in asset that is very specific to an exchange with another party creates an acute problem of vulnerability for the weaker party forced to maintain the exchange relationship that, in the joint presence of opportunism and bounded rationality, makes contract-based market transactions a highly inefficient alternative for the weaker party. Thus, asset specificity generates a hold-up problem for at least one of the parties, which may be taken hostages by the other party after the former invests in the highly specific assets.

Williamson stressed the presence of asset specificity as a critical determinant of transaction costs (Williamson 1985). In this context, the party that invests in highly specific assets would either limit the invested amount or suffer high costs of managing the contractual relationship in order to avoid possible abuse from the other party. In both cases managing the relationship through contractual market exchanges would incur higher costs than integrating both actors within a hierarchy, though some governance costs would obviously be suffered within the hierarchy as well.

A comparative advantage of the transactional theory lies in the fact that it clearly revealed the nature of a firm as one of economic coordination types, and its tools demonstrated its efficiency in order to explain the realities of firms in the countries with developed market economies. At the same time, it should be noted that the implicit premise of the transactional theory is regarding a “norm” of the basic parameters of the institutional environment of the countries with developed market economies, especially the Anglo-Saxon. In this context the following question arises: to what extent is it an applicable tool for the analysis of business structures in the countries with various developed parameters of the institutional environment and other forms of business organization.

In this regard the phenomenon of business groups is of a particular importance as it is a major form of big business organization in developing countries. The need to explain the existence and sustainable development of this atypical form of a firm is a challenge to the transactional theory of the firm.

The business group is a set of formally independent firms operating in unrelated industries controlled by the owners who usually represent a clan or a family group. The main characteristics of business groups are deviations from a number of “right” and recognized Western institutions and business practices:

Firstly, in terms of modern strategic management it is assumed that a company should concentrate on its core competence; otherwise it loses its competitive advantages (Rumelt, 1982).

Secondly, within the framework of good corporate governance it is assumed that separation of ownership and management is necessary. This is a prerequisite for the institutions developed to protect the interests of shareholders (especially
minority shareholders) and a company’s creditors (Johnson, 2000).

Thirdly, the norm of relations between business and government agencies in developed countries is lobbying — the pressure on the legislatures from organizations representing sectoral or regional interest groups. In developing countries the relationship between government and big business manifests itself in a personalized support of individual business structures at the level of administrative and judicial decisions, clearly described as corruption and crony capitalism by Western scholars.

Thus, business groups is a typical object of study for economists, and that is why the sociologists became the pioneers of business groups research. One of the characteristics of a business groups is control over it by a group of people who are usually closely related by friendship, kinship or ethnic ties. This feature of a business group is of a great interest for economic sociology because the key concept of today’s economic sociology is “embeddedness” that reflects the process by which social relationships determine economic actions. According to this logic, business groups root in the system of exchange that promotes economic efficiency through inter-firm resource pooling, cooperation and coordinated adaptation. Even the forms of economic organization, that emerged in the countries with approximately the same level of development and have significant similarities in culture and social organization, can be very different which in its turn leads to different trajectories of economic growth.

In the framework of economic sociology there are two approaches to the research of national forms of business groups: cultural and institutional. Followers of the cultural approach (Fukuyama, Redding) consider an organization to be “a cultural artifact” manifesting deep values of society. One of the leaders of this approach is Francis Fukuyama. From his perspective, a form of economic organization depends on the level of trust between members of society.

Unlike the representatives of the cultural approach, focusing on a system of values, institutionalists (Powell, DiMaggio) focus on the institutional environment’s influence on the organizational structure. From their perspective, the organizational structure can evolve adapting to changing institutions. Thus, if the cultural approach is static, the institutional approach shows the dynamics.

However, with the laps of time economic approaches have been proposed to explain existence of business groups. There are two main approaches. Both are based on the transactional theory of the firm, but if the former is based upon the agency theory, the latter is the economy of transaction costs. The first approach implies the analysis of business groups from the standpoint of corporate governance in which business groups are regarded as “pyramids”. The concept of “a pyramid” was proposed by Johnson et al. (2007). It considers business groups to serve as the devices that let a not numerous group of owners control assets pushing other shareholders (the process is termed as “tunneling”).

Another approach to business groups research is the concept of institutional voids proposed by Hanna (Hanna, 2007). Within this concept which adheres to Hanna, Paleru, Rivkin, Yafeh a business group is regarded as a sub-optimal way of solving the problem of missing or improperly functioning institutions: property rights protection, the capital market, the market for managerial talent. Thus, from these authors’ perspective the best solution is direct borrowing of Western institutions, but during their absence or improper functioning a business group performs their function (i.e., a business group acts as a second-best decision, it internalizes certain types of transactions which would be carried out in the markets in a different institutional environment).
It is important to mention that both concepts (those of “tunneling” and “institutional voids”) consider a business group a deviation from “normal” with the only difference that the latter approach regards it as a negative effect for national economies while the former one characterizes it as generally a positive one.

At the same time the proposed explanations cannot yet be considered an adequate response to the challenge posed to the transactional theory of the firm by the existence of business groups. Business groups are regarded as some kind of deviation that does not fit into the overall typology of firms, as proposed in the framework of the transactional theory.

From our point of view business groups and companies of the Western type should be considered as discrete institutional alternatives, the comparative advantages of each is determined by the institutional environment (Table 2).

The most important parameter of an institutional environment is the political market structure. Countries with developed market economies have relatively open political markets. In the countries with the markets of such a kind the political resource for business acts as club goods, access to which is provided through the system of political lobbying. However, access to political resources improves the framework conditions for the functioning of business or industry, but it does not become a private asset held by individual owners. In most countries there are closed political markets. Under the conditions of closed markets existence the political resource gets internalized, becomes the individuals’ property. Under these conditions an increasing range of the resources owners are involved in the establishment of firms. Along with the owners of business resources and financial capital they are the owners of a political resource.

The benefits that some firms derive from their exclusive relationship with the top officials have always attracted researchers’ considerable attention, primarily in the context of the analysis of economic growth in developing countries; even while different authors use different terminology and different theoretical concepts: “political connections”, “politically favored firms”, “crony economy”, “state capture”.

Nevertheless, these works make it possible to:
1) quantify the benefits from the use of political resources which are firm;
2) identify the mechanisms of using political resources for competitive advantage;
3) determine which firms are most likely to get preferential treatment from the state.

Fisman in his pioneering research analyzes the impact of rumors about Indonesian president

<table>
<thead>
<tr>
<th>Table 2. Differences between a business group and a company</th>
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<tbody>
<tr>
<td><strong>Development</strong></td>
</tr>
<tr>
<td>Business group</td>
</tr>
<tr>
<td>Diversification into unrelated industries</td>
</tr>
<tr>
<td>Company</td>
</tr>
<tr>
<td>Concentration on “core competencies” – some commodity group, or a processing chain</td>
</tr>
<tr>
<td><strong>Ownership structure</strong></td>
</tr>
<tr>
<td>Business group</td>
</tr>
<tr>
<td>Situational, deliberately confusing, indehiscent, characterized by the use of pyramidal structures to concentrate control in a small group of owners</td>
</tr>
<tr>
<td>Company</td>
</tr>
<tr>
<td>A stable, disperse, significant role of institutional investors</td>
</tr>
<tr>
<td><strong>Decision-making mechanism</strong></td>
</tr>
<tr>
<td>Business group</td>
</tr>
<tr>
<td>Fundamentally nontransparent</td>
</tr>
<tr>
<td>Company</td>
</tr>
<tr>
<td>Striving to fulfill the rules of “good corporate governance”</td>
</tr>
</tbody>
</table>
Sukharto’s health during his last year in power on capitalization of companies with varied degree of political influence (Fisman, 2001). A highly centralized and stable political structure of Indonesia made it possible to form a credible index of political ties, while in the countries where political decisions are decentralized the identification of political connections is a daunting task. The analysis showed that the influence of rumors on the stock price of politically influential firms was significantly higher than their influence on the stock price of the companies with no or less political influence.

Fisman’s research was followed by a significant number of works on quantitative assessment of the impact of political influence on firms’ performance. Thus, Johnson and Mitton demonstrated how 1997-1998 Asian economic crisis reduced the expected value of government subsidies to the politically influential firms in Malaysia (Johnson and Mitton, 2003). Data before and after the introduction of restrictions on capital movement in Malaysia were analyzed in the research. The authors showed that capital control can be viewed as an essential part of capitalism based on political connections (cronyism). Policy makers give informal guidance to the banks to approve loans for selected firms; this policy is relatively easier to implement provided a country is isolated from international capital flows. As a result, firms with political connections are more vulnerable to macroeconomic shocks as they reduce the ability of the government to grant them privileges and subsidies. Simon Johnson and Todd Mitton’s work is also based on a predefined list of politically influential firms with identification of policy makers related with specific firms.

Khwaja and Mian analyze the influence of political connections on the probability of obtaining bank loans in Pakistan (Khwaja and Mian, 2005). The authors classify a firm as “political” if its director participated in elections. The results show that political firms borrow 45 per cent more and have 50 per cent higher default rates. It is important to note that such preferential treatment is received only from the state banks. In addition, the research shows a positive correlation between a firm’s affiliation with a business group and the probability of obtaining politically motivated lending; while the larger a business group is the greater the likelihood of getting loans is.

In all the researches mentioned above the authors firstly form a list of politically influential firms based on some factors (election campaigns funding, financing of specific politicians or parties, party membership of managers and company owners, the presence of top officials on the boards of directors, etc.) and then evaluate if politically influential firms get some specific benefits or privileges. It should be noted that the analysis of a political decision-making process in terms of the factors that make companies politically influential is complicated as collecting and interpretation of the data is impeded. For example, the firms which are actually less politically influential may be forced to fund a leading political party while more politically influential firms may be free from this obligation. Also, the possession of deputy immunity by a firm owner may be a strategy of defense from legal prosecution but not a way to get political influence.

An alternative strategy of the political connections research is based on the analysis of political decisions and the benefits that some firms derive from them. The research by Slinko et al. follows this strategy (Slinko, Zhuravskaya, Yakovlev, 2004). On the basis of the Russian legislation in 1992-2000 the authors created a measure of preferential treatment of firms from regional governments and evaluated the effects of preferential treatment on politically
influential firms. In comparison with the firms without political influence influential firms' sales and employment grew faster; they invested more and received more profit. Investigating the issue of the firms that received preferential treatment, Yakovlev and Zhuravskaya showed that a firm’s political influence is determined by a firm’s size and ownership structure: big firms (both in terms of sales and employment) and firms that are controlled by “federal oligarchs” have significantly higher likelihood of getting preferential treatment (Zhuravskaya, Yakovlev, 2004).

Research of political connections between government and business, as well as the benefits that some firms get from their special relationship with the authorities show that:

1. A political resource makes it possible for the firms to get a preferential access to other resources, especially capital, both to bank financing and to equity (the market values the firms which are more politically powerful). This effect can be measured quantitatively.

2. Formally independent firms in a highly diversified structure are more likely to get preferential treatment.

3. The mechanisms through which a firm benefits from the use of political resources are very diverse: tax breaks, investment credits, subsidies, loans guaranteed by regional budgets, official delays in tax payments, transfer of state property.

A political resource is not specific to the industry (although it is natural to assume that its value also varies from industry to industry: in industries with more stringent regulation it is greater). Whether a political resource becomes a source of a sustainable competitive advantage is determined by the institutional environment, and namely the type of political market inherent in a given country.

It is therefore necessary to characterize the notion of “the political market” highlighting its “extensive” and “narrow” interpretations. In a “broader” sense the political market is “the market of power”, the system of trading with a political resource. In a “narrow” sense it is a classical political market which appears within the institutional framework enshrining a democratic organization of a society’s political subsystem. It is the subject of analysis in the public choice theory the focus of which is a political choice in terms of direct and representative democracy. A classical political market should be considered in connection with a bureaucratic (administrative) market, typical for the Soviet economic system in particular as a discrete institutional alternative of a political market organization in a broader sense.

The hybrid of political and bureaucratic markets is typical for today’s developing and post-socialist countries. A “hybrid” nature of prevailing political and bureaucratic markets shows itself in the following:

1. Political, bureaucratic and economic exchanges really merge despite their formal separation.

2. Political transactions get “bureaucratized”, bureaucratic ones get “ politicized”. “Bureaucratization” manifests itself in the fact that the actors’ competitiveness in politics and business is determined by their status in a political hierarchy. On the other hand, “bureaucrats” and “entrepreneurs” behave like “politicians”, they are eager to increase their political resource. Under these circumstances, both state officials and the most influential businessmen are interested in closing the access to a political resource in the framework of “a private club”. State officials do not only extract economic benefits but also consolidate their positions in a political hierarchy. Businessmen are getting interested in increasing investment
in extensive network of personal relationships with government officials.

The current structure of the political market determines how entrepreneurs get access to a political resource and returns from it.

In the countries where classical political markets entrenched, lobbying that is the pressure on the legislatures from the organizations representing sectoral or regional interest groups is the norm of relationships between business entities and the state. This means that entrepreneurs have access to the political resources through collective action. In this case it appears to them as a public good providing a favorable framework conditions for entrepreneurship but it does not become a source of a competitive advantage for individual business. When there are no relatively open political markets a political resource gets internalized within business

<table>
<thead>
<tr>
<th>The subjects of the market</th>
<th>Voters, politicians and pressure groups</th>
<th>Various interest groups within a single formal administrative hierarchy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Type of institutional arrangements</td>
<td>Mostly legal, between subjects, which serve as property carriers (principal - the voter, and his agents’ policy)</td>
<td>As a rule, illegal and status (between disparate entities)</td>
</tr>
<tr>
<td>The model of economic behavior</td>
<td>The more competitive and coordinated the market is, the more efficient the distribution of property rights is. This leads to the establishment of hard budget constraints.</td>
<td>There is a continuing erosion of a formal state ownership by illegal assignment of property rights by “interest groups”. Soft budget constraints get fixed, the degree of softness is different for different interest groups, the higher the status is the softer budget constraints are.</td>
</tr>
</tbody>
</table>

Table 3. Comparative characteristics of bureaucratic and political markets

![Fig. 1. Internalization of a “political resource” in a business group](image)
groups, transactions are carried out through personalized communication (Fig. 1).

Internalization of a political resource also means “washing out” of private property. According to the neo-institutional economic theory (Grossman-Hart’s model) signs of an asset owner is possession of the bundle of two rights: residual control (the right to take any decisions about use of the asset minus those that are explicitly defined by law and transferred to other parties in accordance with the contract) and residual income (income left after payments to all other parties). State officials act as real property rights owners because they have residual control and income right.

Our analysis makes it possible to outline the theoretical approaches and respond to the challenge that the transactional theory of the firm faces due to existence of business groups. From our point of view, a full response to this challenge is in expanding the subject of the transactional theory research that implies the necessity to analyze the owners of an internalized political resource. Under this approach large business owners are either financial capital owners or internalized political resource owners. This depends on the parameters of an institutional environment. In the first case a leading organizational form is a company that usually exists in the form of a public corporation, in the second case it is a business group.

Interesting approaches to this problem can be found in the concept of limited access order (North, D.C., Wallis, J.J., Weingast, B.R. Violence and social order: a conceptual framework for interpreting recorded human history. Cambridge University Press, 2009.).

References


**Бизнес-группа:**
вызов для трансакционной теории фирмы

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В статье анализируется вызов, с которым столкнулась трансакционная теория фирмы в связи с доминированием в экономиках развивающихся стран такой организационной формы, как бизнес-группа. В качестве ответа на данный вызов предложено расширение предмета исследования трансакционной теории фирмы за счет включения в анализ собственников интернационализированного политического ресурса. В рамках такого подхода в зависимости от параметров институциональной среды в качестве собственников выступают либо владельцы финансового капитала, либо владельцы интернационализированного политического ресурса. В первом случае мы получаем компанию, как правило, существующую в виде открытой корпорации, а во втором — бизнес-группу.

Ключевые слова: трансакционная теория фирмы, бизнес-группы, политический рынок, интернационализация политического ресурса.

Статья написана в рамках гранта РФФИ № 12-06-00290 «Специфика политического ресурса российских предпринимателей и его влияние на инновационное развитие» (2012-2013).