

SUPPLY CHAIN

Rethinking Procurement in the Era of Globalization

Frank A.G. den Butter and Kees A. Linse

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The role of procurement within global companies has changed dramatically over the past 25 years from that of simply buying goods and services to overseeing an integrated set of management functions. This brings new challenges and opportunities to procurement. Offshoring and the increased emphasis on specialization and fragmentation of production enhance the strategic character of procurement decisions. Increasingly, procurement decisions have become intertwined with strategic management in general. In this article, the authors discuss the changes in procurement from the perspective of transaction cost economics. They separate transaction costs into "soft" and "hard" costs and differentiate between the internal and external factors that affect these costs. In making procurement decisions, the authors argue, managers need to consider the full range of cost elements. In addition to traditional transaction costs such as transport costs and tariffs, managers need to recognize such elements as cultural and legal differences, government regulation, social preferences, environmental issues, political stability and risks involved in unethical business behavior. The authors argue that knowing the risks and opportunities of the different exposures is a critical management competence. Although management decisions originate in many different parts of the company, procurement managers need to keep a close eye on the various cost exposures and flag concerns as they arise. Procurement, therefore, will need to become more closely connected with strategic decisions throughout the company. This broader view represents a major extension of the concept of total cost of ownership in procurement decisions. Global sourcing creates many new opportunities for value creation, which well-run companies must learn to take advantage of.

Frank A.G. den Butter is a professor of economics at Vrije Universiteit Amsterdam, The Netherlands. **Kees A. Linse** is director of common infrastructure management at Royal Dutch Shell plc. Comment on this article or contact the authors at smrfeedback@mit.edu.

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Rethinking Procurement in the Era of Globalization

What used to be a matter of finding and purchasing goods and services at the most favorable price has changed. At some companies, procurement has become closely intertwined with strategic decision-making and board policy at the highest levels of the organization.

Frank A.G. den Butter and Kees A. Linse

Bio: Frank A.G. den Butter is a professor of economics at Vrije Universiteit, in Amsterdam, The Netherlands. Kees A. Linse is Director of Common Infrastructure for Shared Services at Royal Dutch Shell Plc, in The Hague.

Over the past 25 years, the role of procurement within companies has changed dramatically from that of simply buying goods and services to overseeing an integrated set of management functions. Procurement has crept into every aspect of management, from category management to managing supplier relationships, to contracts and payments, to strategy. As companies look beyond short-term costs and the scope of procurement-related issues has grown, procurement professionals are paying more attention not just to what they spend on goods and services but to the broader costs of operating, maintaining, and replacing the items and resources they purchase over time.

Despite procurement's increased level of importance, it has yet to achieve the level of high-level recognition it deserves. There are two main reasons for this. First, it is often difficult to document procurement's specific contributions: Were the cost savings the result of skillful negotiations with vendors or a fortuitous shift in the market? In addition, the financial benefits of a favorable procurement deal often extend beyond the initial purchase price to other aspects of performance (for example, improved working capital, or reduced financing costs), so there is more than one bottom line to consider. Second, the line between the responsibilities of procurement and those of other stakeholders can be ambiguous. The result: procurement often shares whatever successes it achieves with other groups; for failure, however, it typically gets all the blame.

The need to place procurement in a broader strategic context has become all the more pressing in the current era of increasing globalization. Global sourcing links procurement decisions to strategic decisions. "Make or buy" decisions – for example, should you offshore production to your own subsidiaries or outsource it to outside producers and subcontractors? – are typically made at the senior executive levels. However, other important decisions (such as where to buy,

from whom, and under what conditions) are usually handled by procurement professionals. The reality is that these decisions are no longer based entirely on an understanding of direct purchase costs or on easily observable transaction costs, such as transport costs and import duties, but on many other types of transaction costs as well, including those related to cultural, institutional and political differences. In this article, we will explore the role of these other transaction costs in sourcing decisions and offer a new framework for evaluating costs associated with sourcing and procurement in an increasingly globalized market.

The Role of Transaction Costs

Traditional economic theory ignored transaction costs and assumed that trade was frictionless. However, trade transactions, by their very nature, involve transaction costs.ⁱ A necessary condition for exchange is that one can *ex ante* commit to being able and willing to fulfil contractual obligations *ex post*. Neither buyers nor sellers will enter into exchange relationships unless they are confident that the other party will fulfil the contractual obligations. The problem can be solved in different ways.ⁱⁱ The exchange can be defined institutionally (for example, in a legally binding contract), but it can also be defined by trust and by providing incentives for trustworthy behavior (for example, through bonding networks, where not fulfilling the contractual obligation leads to a costly exclusion from the network).

This fundamental problem of exchange triggers various types of transaction costs, which can vary based on the way the problem is solved. Practically speaking, transaction costs consist of all the costs incurred in the course of acquiring goods and services, either by exchanging property rights in a market transaction or by exchanging responsibilities: all the expenses and time spent coordinating the purchase of goods and services. The “hard” costs are relatively easy to quantify—items such as transport charges, import levies, and tariffs. “Soft” costs, on the other hand, are less accessible and less clearly defined. They include the costs of creating and checking contracts, information costs, costs resulting from cultural differences and communication failures, knowledge of legal procedures, costs incurred in building trust and reputation, network building, costs associated with risk (including regulation), and security requirements.ⁱⁱⁱ

As distances between trading partners grow and economic, cultural, political, and social systems converge in a globalized market, the soft costs become more important, and procurement becomes a more strategically important area. Indeed, the ability to purchase goods or services at the lowest possible price is often less critical than developing effective ways of bridging cultural difference and overcoming informal trade barriers^{iv}. However, reducing transaction costs cannot be achieved by decisions of the procurement department alone. Because of the wide range of costs and their effects, it requires strategic decisions by top management. As procurement managers look beyond traditional cost considerations, top management must define their priorities and deal with different cost categories.

Strategic Transaction Management

The ongoing trend of globalization has brought about increased movement toward specialization and fragmentation of production as manifested by growth in outsourcing, global sourcing, and direct foreign investments. Dramatic growth rates in countries with lower production costs (including India and China) have given rise to a sense of urgency within companies operating internationally as to how they can continue to create value through trade. One option is to switch from captive production to becoming a leader in orchestrating production—developing expertise in where to produce, assemble, and sell. It requires changing the way companies go about managing transactions and how international trade relationships are established. In doing so, companies can acquire critical knowledge about how transaction costs can be reduced. In fact, it works two ways. Lower transaction costs will enable further fragmentation of production and outsourcing of specialized tasks because they make outsourcing profitable^v. At the same time, enhanced knowledge about the costs of outsourcing (in particular, knowing when outsourcing isn't profitable due to unexpectedly high “soft” transaction costs) can lead to further reductions in transaction costs.

Knowledge of transaction costs is a critical part of trade and investment decisions. It allows companies to reduce their overall costs, thereby making existing trade more profitable and opening the door to higher volumes of trade. Knowing how to keep transaction costs low is something we call transaction management. Effective transaction management can create value for both individual companies and society as a whole.

As transaction costs are reduced, they will become a smaller part of the total supply cost in *current trade*. But there are compelling reasons for companies to remain focused on this area. Good transaction management and lower transaction costs will increase the number of profitable trade transactions and lead to further fragmentation of supply chains. In the process, production processes will undergo changes; with increased outsourcing, there will be fewer direct production costs and more transaction costs. On balance, *new trade* (from outsourcing more parts of the supply chain) will have higher transaction costs in relation to the total supply costs.

The strategic character of transaction management is highlighted by the fact that institutions, including the legal infrastructure, the banking system, and the regulatory and political systems, are all highly influential in how transactions are managed. Different institutions shape transactions in different ways—for example, whether the transactions are handled formally (with legal contracts) or informally (through trust-based relationships). Although globalization has spurred significant convergence in the institutional environment, cultural, legal, and social differences continue to be barriers in some countries and regions. For example, the trading norms that are accepted in continental Europe and the English-speaking world do not always line up with how things are done in the Middle East and Asia. For managers seeking to reduce transaction costs, understanding the cultural, legal, and social differences is critical.

Transaction Management for Procurement

Procurement professionals have an essential role to play in managing the complex interface between companies and stakeholders to maximize value. In today's transparent global economy, procurement managers will have to identify and manage not only the different sources of transaction costs. They will need to do this in areas where they have varying degrees of control or influence. To assist management in understanding its cost exposure, we find it helpful to consider transaction costs along two dimensions: 1) in terms of objective and subjective issues; and 2) in terms of internal and external influences:

Objective and subjective issues. Objective issues are tied to measurable factors and are of a technical or professional nature. They are usually linked to financial issues such as direct costs, improved quality, on time delivery, transportation cost, and life-cycle cost. Subjective factors, by contrast, are related to emotional, religious, or intuitive views about the world and how it connects with the organization. Although not overtly related to finance, such issues (for example, unethical business behavior, diminished confidence in a brand, or adversarial labor relations) can result in significant transaction costs and have major financial implications.

Internal and external factors. By internal factors, we mean factors related to the specific business: its market position, and its reputation and brand. These are distinct from external factors, which are tied to developments outside the company in areas such as regulation, labor costs, and currencies.

The combinations of internal, external, objective, and subjective factors create a complex spectrum of exposures that can affect the financial health of a company, if not its very existence. In a global economy, knowing the risks and opportunities of the different exposures is a critical management competence (see "Classification of Costs in Procurement"). Although management decisions will originate in many different parts of the company, procurement managers will need to keep a close eye on the various cost exposures and flag concerns as they arise. Procurement, therefore, will need to become more closely connected with strategic decisions throughout the company.

Companies strive to minimize the total cost of ownership (TCO). Based on our analysis of cost factors, the TCO consists of:

1. The direct cost of acquisition, which is the original purchase cost;
2. The further cost, which is related to owning the equipment or business, such as installation, maintenance, energy consumption, disposal etc.
3. All transaction costs related to acquisition and further cost.

The direct cost of acquisition and the further cost are the two factors that typically drive purchase decisions. They are largely related to objective costs (as noted in the table). The first step in extending the purchaser's decision framework is to identify transaction costs as a cost category that needs to be managed separately. The second step is to give subjective costs the same level of attention as objective costs. Finally, purchasers must acknowledge that many of the soft issues do

not just operate within the decision framework of procurement but are integral to the strategic position of the company; hence they need to be addressed by a wider management group.

An alternative way to view procurement is to look at the day-to-day activities procurement professionals manage (see “Contact, Contract and Control”). This adds the time dimension of decision making to our objective/subjective and internal/external framework. However, it would be a mistake to conclude that the day-to-day activities will reflect the variety of transaction costs covered by our framework. In particular, procurement professionals must be prepared to address issues of accountability, issues of optimization, and issues of compliance to ensure that transaction costs are identified and properly addressed.

Accountability. Procurement professionals need to assume accountability not only for purchasing but also for managing the complete transaction. Although procurement specialists are often familiar with many types of transaction costs, many lack a full appreciation of the effects some costs have on the overall economics.

Optimization. Once the transaction costs are known, the challenge is figuring out how to optimize them in relation to the total cost of ownership. This means knowing where costs can be minimized and knowing where they are necessary to achieve optimal procurement results. For example, transaction costs may be acceptable in a situation where innovative or key strategic goods or services of very high value to the company are being procured and where security of supply is of prime importance. On the other hand, for routine or commodity goods or services the cost is of prime importance and transaction cost will need to be avoided or minimized.

Compliance. Even if transaction costs are properly identified for every stage of the procurement lifecycle, their benefits may not be realized due to non-compliance during the implementation of the acquisition process. In today’s global market, compliance management is more important than ever.

Managing the Soft Side of Procurement

The importance of detailing and managing hard costs on a category-by-category basis cannot be overstated. However, a major part of the globalization challenge is figuring out how to conduct business both profitably and ethically, which requires a more comprehensive understanding of how to manage the “soft” issues (for example, the trade-offs between the environment and profits). Decisions to source products offshore—for example, outsourcing parts production and services—often lead to higher transaction costs than originally expected. This has implications for regional employment and economic growth because these transaction costs may affect profitability of outsourcing and reduce economic activity. It may, moreover, lead to social unrest at home and a loss of trust in the company, which can give rise to a *new* set of transaction costs.

Classification of Costs in Procurement

Objective (“hard”) Factors	Internal Factors (decisions within company control)	<ul style="list-style-type: none"> • Search and information cost connected with identifying suppliers • Direct cost of acquisition • Transport cost • Quality assurance • Installation and maintenance cost • Intellectual property costs • Training
	External Factors (decisions controlled by others)	<ul style="list-style-type: none"> • Legislation in relation to trade • Currency effects • Import/export permits, levies • Labor costs and safety standards • Government rules and regulations
Subjective (“soft”) factors	Internal Factors (decisions within company control)	<ul style="list-style-type: none"> • The effect of sourcing decisions on existing jobs • The effects on reputation and brand value • Corporate culture: Will staff support new suppliers? • Sustainability tradeoffs inside the company • Risk aversion: Will staff be able to deal with the risks associated with new supply options?
	External Factors (decisions controlled by others)	<ul style="list-style-type: none"> • Sustainability considerations in relation to local and global economic environments • Cultural differences connected with doing business • Political differences concerning democratic rights, distribution of wealth, unions, and political stability • Customer views on desirable sources/suppliers • Labour circumstances • Environment

Decisions to address issues of environmental sustainability in a responsible way or to create attractive working conditions for employees may result in higher transaction costs in the short term (in the form of higher production costs or more expensive training). In the long run, however, these investments may lead to lower transaction costs (resulting from a good reputation and the ability to attract the most motivated workers). Therefore, in balancing the trade-offs between short-term and long-term costs, ethical corporate behavior can be rational. Different companies will make these decisions in different ways, depending on the way they value the risk

and costs of a reputation loss and depending on how managers are emotionally or politically positioned in relation to these issues.

Senior managers at global companies need to recognize that the role of procurement professionals is changing. What used to be a matter of finding and purchasing goods and services at a favorable price has become closely intertwined with strategic decision-making and board policy at the highest levels of the organization. Global sourcing creates many new opportunities for value creation, which well-run companies must learn to take advantage of.

The table lists the various types of costs that need to be considered in today's procurement decisions. It emphasizes the role of transaction costs, especially "soft" transaction costs. These costs are becoming increasingly important and have made procurement an essential part of strategic decision-making at global companies.

Sidebar

Transaction Costs By Stage of Procurement

Transaction costs can be grouped into three categories that are aligned with potential trade transactions: costs associated with contact; costs associated with contract; the costs associated with control.

Contact In the *contact* phase, the buyer seeks information about his preferred product (price and quality), potential suppliers, or, when the product does not yet exist, which producer might be able to develop and/or produce it. The seller, for his part, devotes marketing effort into looking for a buyer. At this stage, the transaction costs are mainly for search and information. However, they are sunk costs—they occur even if a trade relationship (purchase) is not established.

Contract The *contract* phase starts immediately after the potential trading partners have found each other and begin working toward a deal. The costs in this period revolve around negotiating the terms of the contract. Parties have to decide how to divide expected rents of the transaction and how to protect their respective interests.

Control The *control* phase involves monitoring and enforcing the contract. Both monitoring and enforcement involve high transaction costs, especially when large distances separate the trading partners and suppliers from each other. Now that physical distances have become less important through reduced transportation costs and fast communication, cultural and institutional distance can still be large. Business partners need to monitor the terms of their agreements to verify whether the other party is doing what it promised to do. If there are problems, the next step is enforcement of the contract. The most common response is to start a legal procedure. Especially in international trading relationships, legal actions take both time and money. Moreover, foreigners often have difficulties in national courts when they file claims against a local company.

About the research

This research combines two different perspectives: government policy making and corporate decision making. Prof. den Butter was responsible for the report on "The Netherlands as a Trading Nation," published in 2003, which recommended increasing trade through low transaction costs. ^{vi}

As formal trade barriers disappear, the report pointed out that “soft” transaction costs will become increasingly important, requiring countries to make knowledge investments. Dr. Linse, who organized a conference for procurement officers in late 2007, worked with Prof. den Butter to evaluate how areas such as sustainable development and ethical behavior should be reflected in transaction costs.

Executive Briefing

The ongoing trend of globalization in recent decades brings new challenges and opportunities to procurement. Offshoring and the increased emphasis on specialization and fragmentation of production enhance the strategic character of procurement decisions. Increasingly, procurement decisions have become intertwined with strategic management in general. In this article, the authors discuss the changes in procurement from the perspective of transaction cost economics. They separate transactions costs into ‘soft’ and ‘hard’ costs and differentiate between the internal and external factors that affect these costs. In making procurement decisions, the authors argue, managers need to consider all of these cost elements. From that perspective the cost elements provide a kind of “checklist” for the procurement profession and for the general management of a company for a judgment on the importance of various types of costs. In addition to traditional transaction costs such as transport costs and tariffs, they need to factor in such elements as cultural and legal differences, government regulation, social preferences, environmental issues, political stability and risks involved in non-ethical business behavior. This provides a major extension of the concept of total costs of ownership in procurement decisions.

Endnotes

ⁱ Ronald Coase, winner of the Nobel Prize for economics in 1991, introduced the concept of transaction costs in economic theory: R.H. Coase, “The Nature of the Firm”, *Economica* N.S. 4 (1937): 386-405; R.H. Coase, “The Institutional Structure of Production”, *American Economic Review*.82 (1992): 713-719, 1992. Nowadays transaction cost economics has become a major field : O.E. Williamson, “Transaction Cost Economics: How it Works; Where it is Headed”, *De Economist* 146: 23-58, 1992; D.C. North, and J.J. Wallis, “Measuring the Transaction Sector in the American Economy: 1870-1970”, in “Long Term Factors in American Economic Growth”, S. Engerman and R. Gallman (eds.) (Chicago: Chicago University Press, 1986): 95-161.

ⁱⁱ Greif elaborates the fundamental problem of exchange by showing how various institutions provide different solutions for the problem. That brings about different types of transaction costs: A. Greif, “The Fundamental Problem of Exchange: a Research Agenda in Historical Institutional Analysis”, *European Review of Economic History* 4 (2000): 251-284. For instance, the belief that the contract will be fulfilled may stem from a formal legal obligation, but can also be based on the reputation of trustworthiness of the trading partner. In the first case transaction costs will mainly depend on the quality of the legal system, and in the second case they will depend on the bonding of the trust relation.

ⁱⁱⁱ A particularly noteworthy factor on the “soft” side of procurement is trust. On the one hand, building trust and developing a reputation requires investment, which leads to higher transaction costs. However, once suppliers and clients have established trust, they can anticipate lower transaction costs. Building trust and encouraging trustworthy behavior also has benefits for society as a whole, creating positive externalities. Damaged trust and reputation not only hurts companies in the form of high transaction costs; it harms society as a whole.. See e.g. F.A.G. den Butter and R.H.J. Mosch, “Trade, Trust and Transaction Costs”, “Tinbergen Institute Discussion Paper” TI 2003-082/3 (2003).

^{iv} Informal trade barriers relate to red tape, tacit knowledge on how institutions work, uncertain and hazardous interpretation of rules and regulations, etc.

^v In this respect Grossman and Rossi-Hansberg argue that the theory of international trade should consider comparative advantages of trade in tasks rather than of trade in products and services: G.M. Grossman and E. Rossi-Hansberg, “Trading Tasks: a Simple Theory of Offshoring, NBER Working Paper, no. W12721 (2007).

^{vi} Scientific Council for Government Policy (WRR), “Nederland Handelsland: het Perspectief van de Transactiekosten (The Netherlands as a Trading Nation: the Transaction Costs Perspective)”, “Reports to the Government” no. 66, (The Hague Sdu Uitgevers 2003)