

PERCEIVED IMPACT OF THE MARKET ON THE BUSINESS OF REGIONAL CONTRACTORS: A SOUTH AFRICAN CONTEXT

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The economic system is central to the wellbeing of all industrial sectors, especially the construction industry. During economic stability and growth, the construction industry has been observed to thrive in terms of full order books and high levels of profitability. However, in period of limited economic growth, increased competition for works that beget opportunism seems to be rampant in the industry. The principal subject area researched is the impact that economic cycles that leads to sluggish state of the economy has on the competitiveness of the business of regional contractors that are focussed on private sector projects. The methodological approach adopted for the discourse is quantitative in nature as a semi structured questionnaire was distributed among a purposive sample of general contractors (GCs) registered with the East Cape Master Builders Association (ECMBA). Selected findings suggest that in the area of strategic management and transaction cost theory, it would be valuable to assess the factors that would aid regional GCs in South Africa. In addition, there appears to be a need to foster governance structures and strategic thinking attributes that would enable GCs to weather the storm of low order books. The implication is that it is important for GCs to have the ability to deploy strategic management approaches that would ensure the longevity of their firms when outcomes are highly uncertain in the business environment as reputations are difficult to establish and the payoff from opportunism cannot be overlooked in such situations.

Keywords: construction, economic cycle, transaction cost, South Africa.

BACKGROUND

The effects of the recent economic crisis have been widespread and they have resulted in significant asset depreciation, closures of organisations, rising unemployment and a severe slowing down of economic growth in most nations. To a lesser extent, this phenomenon has happened in countries in sub-Saharan Africa of which South Africa is considered to be an economic powerhouse. Until the global financial crisis (GFC) hit South Africa in late 2008, economic growth in the country had been stable. Statistics South Africa (STATS SA, 2009) observes that the gross domestic product (GDP) rose by 2.7% in 2001 to 5.1% in 2007 and then declined to 3.1% in 2008. A consequence

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of this decline is construction tendering activities (especially in the private sector) that have dropped dramatically over the past few years.

For example, STATS SA observed that in the 1st quarter of 2009 activities dropped by 24.8% year on year, with a 21.6% drop reported in non-residential developments. The costs of tendering that tend to be high in the industry (Hughes et al., 2001) worsen the state of the balance sheets of firms that have significant numbers of unsuccessful bids. Thome (2011) observe that during economic upswings in South Africa, the construction industry thrives as order books are full and profit margins are high; whereas in times of economic uncertainties, desperations born out of survival tendencies leads firm to engage in practices that have continually tarnish the image of the industry. Volatility in the industry that fosters fraud and corruption in South African construction (Construction Industry Development Board (CIDB), 2011) thus has the potential to increase transaction costs due to 'opportunism' (Hill, 1990).

Hill (1990) suggests that cooperative behaviour solutions (for example partnering) is unable to deal with opportunism when outcomes are highly uncertain, reputation is difficult to establish, and the payoff from opportunism in a prevailing period outweighs the discounted present value of future cooperation. In the context of transaction cost theory, the argument suggests that there is value in the theory that hierarchical governance has efficiency properties when outcomes are highly uncertain (Hill, 1990). Given that factors that engender opportunism can be said to be prevailing at the time of this study, the formulated problem statement that led to the compilation of this paper proposed that instability in economic cycles negatively affects long term profitability of contractors that are focussed on private sector construction projects. The study was embarked upon in order to explore the perceptions of GCs in terms of the boom and bust cycles in the economy and how this affect the construction industry and the competitiveness of firms operating in the business environment.

REVIEW OF THE RELATED LITERATURE

The literature acknowledge that economic cycles that influence decision makers exist, although the cause (or causes) of such cycles is uncertain and varies with respect to each industry and the prejudice of the observer (Allan, Yin & Scheepbouwer, 2008). Generally it is accepted that a rapid growth phase of the cycle causes inflated prices and reduced competition due to full order books; whilst the downward phase leads to competitive cost cutting, lower margins and short cuts that affect quality, which must be monitored if the industry is to free itself of the most negative aspects of boom and bust cycles (Allan et al., 2008). According to Lewis (2004), the construction sector is generally one of the larger and more important sectors of a nation's economy. The construction sector is also one of the most responsive to economic changes in a country. Construction is usually one of the major sources of employment in an economy, and so regulation of the construction sector not only has an important effect on the performance of the economy but also on levels of employment. For all these reasons, it is important to better understand the way the construction industry relates to other sectors of the economy, and to changes in the national economy itself.

As an illustration, De Valence and Runeson (2011) examined the extent that the building industry has been affected by the GFC and the Euro crisis internationally. They surveyed senior academics and executives in construction businesses in Europe, India, China, Hong Kong, Singapore, Korea, the Middle East, Africa, Australia and South America (No-one responded to the study from North America). The responses to the study show that in developed economies the effect has been a substantial

downturn as finance have taken flight (Spain, Greece and Cyprus may serve as examples), while in developing economies demand has been sustained by population growth induced urbanisation that embrace increased development of residential buildings and infrastructure projects (De Valence & Runeson, 2011). Close to home, De Valence and Runeson noted that the 2010 Soccer World Cup coupled with stringent foreign exchange controls played an important role in protecting the South African construction sector from the GFC. However, the reality in 2013 is not the same as the civil engineering sector that is often buoyed by the public sector is rather sluggish despite repeated announcement of budgetary allocations to the sector (Pillay, 2013). Thus, while the GFC has impacted most developed countries significantly (especially in Europe), the South African economy has not been totally insulated from it.

One of the best ways to avoid cyclical behaviour is to have access to accurate economic current information, and where possible, have lead indicators (Allan et al., 2008). This type of information are essential because the construction industry is vulnerable in a period of high market volatility, where mitigating the related risks has become a challenge for owners and contractors alike (Hibbs, 2007). A major reason for the volatility in the industry is due to the constant changes in prices of material and services. Burns (2008) contends that pricing and cost control now necessitates a proactive approach that requires project partners to frequently attend meetings with contractors, sub-contractors, and suppliers in order to ensure a profitable venture.

The construction industry is deemed to be characterised by increasing fierce competition among and / or between professionals and contractors. Such competitive behaviour could potentially promote opportunism (Hill, 1990) and negate the attempt to reduce transaction costs through collaborative working arrangements by project actors (Pryke, 2012). This can be illustrated through the work of Williamson (see Williamson 1979; 1981; 1985; 1998). Williamson's work combined behavioural assumptions with discussions of the causes of transaction costs and why transactions occur within markets. Pryke (2012) noted that Williamson adopted the concepts of bounded rationality and opportunism in a more strictly economic context related to environmental factors in the form of asset specificity, uncertainty and frequency. According to Williamson (1981: 552), "transactions occurs when a good or service is transferred across a technologically separable interface. One stage of activity terminates and another begins. With a well-working interface, as with a well-working machine, these transfers occur smoothly. In mechanical systems, we look for frictions: do the gears mesh, are the parts lubricated, is there needless slippage or other loss of energy? The economic counterpart of friction is transaction cost: do the parties to the exchange operate harmoniously, or are there frequent breakdowns, and other malfunction?"

With this simple machine metaphor, Williamson (1981) was able to define transaction cost. Although the quantification of transaction has previously proved relatively elusive in construction (Pryke, 2012), one of its inherent premise is that the properties of the transaction determines the governance structure of an undertaking (Williamson, 1985) and influence the governance of contractual relations (Williamson, 1979). Williamson (1979) identifies uncertainty, frequency of exchange, and the degree to which investments are transaction-specific as the principal dimensions for describing transactions. He argued that the efficient organization of economic activity entails matching governance structures with these transactional attributes in a discriminating

way. The propagation of an enabling strategy in a firm will serve the purpose of matching governance structures and transaction attributes.

However, there is limited evidence to show that construction firms have adapted formal processes to develop long-term strategies (McGeorge & Zou, 2013) despite the view that organisations that have implemented strategic management concepts as part of their business cornerstones have shown greater improvements in turnover and profits over the years (Ehlers & Lazenby, 2010). According to Behnam & Rasche (2009), strategy formation represents ethical reflection on a corporate level where one is bound by their own individual standards as well as the political and cultural environment in which the organisation operates. In fact, empirical findings have shown that organisations that implement strategic management competencies generally outperform those that do not (Hunger & Wheelen, 2003). According to Hellriegel et al. (2004), such competencies can be nurtured through:

- Understanding the industry by having a fair idea of the history of the industry as well as staying informed about the actions of competitors and strategic partners, and alertness to changes that will create significant threats and opportunities in the industry.
- Understanding the organisation through the ability to manage the concerns of stakeholders by understanding the strengths and limitations of various business strategies; appropriating the distinct competencies of the firm in conjunction with a clear understanding of the various organisational structures via the advantages and disadvantages of each, and the ability to fit into the unique corporate culture of the organisation.
- Taking strategic actions in the form of executing specific plans that reflect cross-functional and divisional knowledge; assigning priorities and making decisions that are consistent with organisational mission and strategic goals; managing the challenges of alternative strategies by considering the long-term implications of actions, and also establishing tactical and operational goals that facilitate strategy implantation.

METHODOLOGY

The research method chosen for this exploratory study was quantitative in nature since the rigor was limited as the project constitutes a partial requirement for the award of a BSc honours degree in a South African university. The quantitative technique used was the survey method. The literature reviewed provides the platform for the set of questions that were asked in the survey. The questions asked pertain to the ratings of certain aspects of the business of construction that are mostly affected by fluctuations in economic cycles; and the consequences of such fluctuations. The extent to which certain practices observable through the reviewed literature contribute to business profitability was also examined.

Given that construction managers, certainly members of the CIOB in Southern Africa have been noted for spending a limited number of years at operational management level, and more at middle and top management level (Smallwood 2006); the primary data that arose from the study were collected by means of a survey that was conducted among middle and top management employees of Eastern Cape based GCs that are members of ECMBA. According to Smallwood (2006), the most frequently used subject areas in the construction management domain reflects the focus at these respective levels of management: top-the management of business of construction; middle-the management of a number of projects and operational-the management of

specific projects. Thus, the rationale for sampling only middle and top management employee is based on their perceived exposure to the business aspects of construction management in South Africa.

The data were therefore collected through a purposive sampling method. Purposive sampling is a procedure in which the research samples whoever he or she believes to be representative of a given population (Springer, 2010). The difference between purposive sampling and probability sampling approaches is that purposive sampling is based on the researcher's informal ideas about representativeness. Although probability sampling is often preferable to purposive sampling, the latter is often used when population characteristics cannot be precisely determined (Springer, 2010).

Through the ECMBA database, the purposive sampling method led to the selection of 87 GCs. Out of this number, only 37 responded, which equates to a 42.5% response rate. In terms of demographic information, 70.2% of the respondents have been in the industry for over 10 years; 45.9% of the GCs have executed project with average contract value above R10m; 85.7% of them were involved in residential projects; and 83.8% of the respondents occupied either a top management or a middle management position in their respective firms.

FINDINGS - THE SURVEY

When the respondents were asked to tick the phrase that best describe the economic climate of the construction industry among four options, which include stable, volatile, constant, and ever changing, it is notable that almost all the respondents ticked volatile and ever changing. It was observed that 91.7% perceive the industry to be volatile, while 96% perceive it to be ever changing. Based on this response, it can be argued that the respondents were of the opinion that there are fluctuations in economic cycles and these fluctuations affect various aspects of the construction business. As indicated in Table 1, profits and tendering were perceived to be mostly affected by fluctuations. The table indicates the perceptions of respondents related to the effect that fluctuations in economic cycles has on certain aspects of a construction business in terms of response percentages ranging from 1 (minor) to 5 (major) and a mean score (MS) ranging between 1.00 and 5.00. It is notable that 59.5% of the respondents were of the opinion that fluctuations in economic cycles have a major effect on profits, while 48.6% of them perceive that fluctuation have a major effect on tendering. In general, given that the MSs related to profits, tendering and morale were above the midpoint score of 3.00, it can be argued that the respondents perceive the effect of fluctuations in economic cycles on these aspects to be more of a major than a minor effect.

Table 1 Aspects of construction business affected by fluctuations in economic cycles

Aspects	Response (%)						MS	Rank
	Unsure	Minor.....Major						
		1	2	3	4	5		
Profits	0.0	0.0	8.1	5.4	27.0	59.5	4.38	1
Tendering	2.7	0.0	5.4	13.5	29.7	48.6	4.25	2
Morale	0.0	5.4	10.8	40.5	18.9	24.3	3.46	3
Ethics	2.8	16.7	19.4	27.8	27.8	5.6	2.86	4
Quality	0.0	21.6	24.3	32.4	10.8	10.8	2.65	5

In addition, Table 2 indicates respondents perceptions associated with consequences of fluctuating economic cycles in the construction context. The table shows the respondents' perceptions of the consequences of economic instability in terms of response percentages ranging from 1 (strongly disagree) to 5 (strongly agree) and an MS ranging between 1.00 and 5.00. It is notable that all MSs in the table are above the midpoint score of 3.00, which suggest that the respondents agreed as opposed to disagreed with the listed consequences. Specifically, redundancy and liquidation were perceived as the most significant consequences of economic instability in the South African construction industry, while loss of expertise and changing of business are equally important eventualities in such situations.

Table 2 Consequences of fluctuations in economic cycles on construction business

Consequences	Response (%)						MS	Rank
	Unsure	Strongly disagree...Strongly agree						
		1	2	3	4	5		
Redundancy	2.7	2.7	5.4	16.2	29.7	43.2	4.08	1
Liquidation	0.0	5.6	2.8	25.0	36.1	30.6	3.83	2
Loss of expertise	2.7	5.4	13.5	21.6	37.8	18.9	3.53	3
Changing of business	0.0	0.0	21.6	37.8	27.0	13.5	3.32	4

Because of observations such as the ones recorded above and others documented in international construction management research (CMR), the management of the business of construction strategically have being advocated in the literature. To this end, questions related to strategic management were posed to the respondents. With a 'Yes, No, and an Unsure option', the respondents were requested to indicate if their organisations engage in the strategic management of their businesses. It is notable that 65% of the respondents affirm that they engage in one form of strategic management or the other. However, all the respondents concurred that reliable information and astute management expertise are required for making appropriate business decisions. Furthermore, 89.2% of them opine that organisations should have strategic intent / vision in order to make appropriate business decisions. 86.5% of the respondents also contend that greater collaboration between key stakeholders is required for optimum business decision-making processes.

In brief, the respondents were of the opinion that certain practices are central to the ability to make profits in the regional construction business environment in South Africa. As indicated in Table 3, 70.3% of the respondents perceive that integrity is paramount for the ability to engender business profitability in the construction industry. The table also suggests that reliability, strategic management competencies, long-term planning, specialisation and diversification are all important practices for survival and increased profitability in the construction business environment. When asked to make general comments associated with the study, 19 respondents put forward arguments that provided additional insights. Such comments, inter-alia, include:

- “Fluctuating economic cycles affect all aspects of the construction industry, but in particular it decreases the level of skills available in the industry”;
- “Economic cycles have a major impact on construction activities, especially in the residential market. Another factor linked to the economy, which influences the construction industry, is the availability of finance”, and
- “Due to fluctuating cycles, regular work is not available to the construction companies who have staff that need to be paid. Companies are thus forced to tender on work at next to nothing margins just to retain their workers and keep them happy. This leads companies to 'cut corners' in order to make small profits that results in decreased quality and unhappy clients”.

Table 3 Extent to which certain practices contribute to business profitability

Practice	Response (%)						MS	Rank
	Unsure	Minor.....				Major		
		1	2	3	4			
Integrity	0.0	0.0	0.0	5.4	24.3	70.3	4.65	1
Reliability	0.0	0.0	0.0	0.0	50.0	50.0	4.50	2
Strategic management competencies	0.0	0.0	2.7	13.5	40.5	43.2	4.24	3
Long term planning	0.0	5.4	2.7	16.2	43.2	32.4	3.95	4
Specialisation	5.4	0.0	5.4	32.4	29.7	27.0	3.83	5
Diversification	2.7	0.0	10.8	32.4	29.7	24.3	3.69	6

Furthermore, some respondent say:

- “Small organisations are constantly in survival mode, while large organisations survive economic cycles by operating outside of South Africa”;
- “In bad times you have to take whatever work is available even if it means tendering at cost just to keep your workforce busy”;
- “Economic cycles govern the highs and lows of the construction industry. Budget constraints and cost control also contribute”;
- “The industry is so volatile, that is makes a mockery of short to medium term planning and the short durations of the cycles make planning for growth and expansion, extremely risky”;
- Clients put industry players under major pressure in economic downturns / recessions. Both contractors and consultants have to engage work at very low

margins. Contractors can only do as much as they allowed for in the tender price. Educated clients know this and don't work with lowest set of tenders", and

- "Economic fluctuations have profound effects on the industry as a whole. Economic downturns lead to unethical practices which leaves the industry with a poor public image. It's a horrible cycle that needs fixing. A stabilised economy would go a long way to relieving the industry of many of its problems but the means of stabilise the economy seems unattainable".

DISCUSSION

Although it has been claimed that long-term survival of construction enterprise depends upon effective strategic management based on sound strategic planning, and strategic thinking has become increasingly important to construction organisations as a result of the industry's dramatically changing business environment (McGeorge & Zou, 2013), it appears that the surveyed GCs have not appropriated this management concept. The findings can be further supported by another empirical finding that emanated from the Eastern Cape region in South Africa. The study amplified the need for GCs to manage their firms / or businesses strategically. The qualitative study that was authored by Adendorff, Appels & Botha (2011) revealed that construction SMEs (small and medium size firms) that practise strategic management perform better than their peers, and that there are many advantages for SMEs that adopt strategic management principles at the organisational level. The case study that profiled an Eastern Cape based GC further indicates that the GC was able to grow its business in spite of the tough economic climate because it adopted management strategies that include diversification and specialisation, among others.

A closer look at the general comments noted that the uncertainties in the business environment may be leading to the prevalence of opportunistic behaviours in the regional market. The comments failed to show a particular strategy that the GCs have adopted in this volatile period. Given that opportunism hinders long-term growth of firms (Hill, 1990; Williamson, 1979; 1998), there appears to be a need for the surveyed GCs (and others in the region) to develop an open framework for corporate strategy in construction in terms of technology, human resources, marketing and competition, business, core competencies, knowledge resources, finance, and operations (see McGeorge & Zou, 2013). Doing this should enable the firms to tackle rising transaction costs (for example, costs pertaining to unsuccessful tenders) and low profit margins in the industry. From the data presented by Hughes (2003), there appears to be no relationship between the type of working methods and the costs of tendering in construction. Hughes (2003) noted that while it can be expensive to get into framework deals and partnering arrangements, the expectation of project actors is that this up-front investment results in lower downstream costs; but there is no evidence to support either of these assertions. He however opined that the findings suggest that there are more influences on these costs than the mere presence or absence of collaborative working methods.

The aforesaid have implication for regional contractors that are not exposed to public sector projects in South Africa. The market mechanism dictates the availability of work in the private sector, especially in the residential building sector. Perhaps the argument of Hill (1990) should be considered in this context. Hill (1990) argued that among a population of economic actors that require investment in specialised assets, behaviours that amplify cooperation, trust, and forgiveness of isolated opportunism by

others does have economic value. Furthermore, Hill (1990) suggests that even in cases that are dominated by small numbers and high switching costs, in the long run opportunism does not yield the anticipated benefits.

CONCLUDING REMARKS

The volatility of the economic system has had a profound effect on the construction industry as problems that are synonymous with the sector are often amplified during economic downswings. Economic fluctuations produce ripple effects that affect a number of key construction business areas. This is particularly apparent during a sluggish economic period that the construction industry is so impacted that GCs and other project actors engage in competitive strategies that are not limited to cost cutting, lower margins, and other practices that would secure the lifespan of businesses. The surveyed literature and regional GCs in South Africa indicate that when situations such as the one described above persist, opportunism may escalate transaction costs in the industry. Although behaviours that engenders opportunism would not serve the corporate goals of a firm in the long-term, it appears that interventions that can address it is not been implemented by the surveyed GCs.

This implies that market mechanism (volatility) can have the risk of opportunism even if actors whose behaviours are habitually opportunistic would eventually leave the scene (Hill, 1990). In other words, as markets move towards the state of competitive on-equilibrium, the risk of opportunism will be high. However, the findings of this exploratory study should be viewed in context because of its inherent limitations. In the area of strategic management and transaction cost theory, it would be valuable to assess the factors that would aid regional GCs in South Africa, especially in an unstable economic environment. Governance structures and strategic thinking attributes that would enable GCs to weather the storm of low order books should be made known in a future study. When outcomes are highly uncertain in a business environment, reputations are difficult to establish and the payoff from opportunism cannot be overlooked; it is important for GCs to have strategic management techniques and / or approaches that would ensure the continued existence of their firms.

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