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Source: *The American Economic Review*, Vol. 88, No. 2, Papers and Proceedings of the Hundred and Tenth Annual Meeting of the American Economic Association (May, 1998), pp. 75-79
Published by: American Economic Association
Stable URL: http://www.jstor.org/stable/116896
Accessed: 21/10/2014 12:50

# The Institutions of Governance

*By* OLIVER E. WILLIAMSON *

The new institutional economics (NIE) is an idea whose time has come. That was evident to R. C. O. Matthews in 1986, who in his presidential address to the Royal Economic Society declared that the NIE was ''one of the liveliest areas in our discipline'' (1986 p. 903) and thereafter described it as a body of thinking based in two propositions: institutions matter, and institutions are *susceptible to analysis* (1986 p. 903). The proposition that institutions matter is embraced by institutional economists of all kinds, old and new. What distinguishes the NIE from earlier (and some contemporary) work on institutions is that institutions are susceptible to analysis. Older-style institutional economics was content to critique orthodoxy and collapsed for failure to advance a positive research agenda (Ronald Coase, 1984; Matthews, 1986). The NIE has responded to the challenge by (i) developing a comparative institutional logic of organization to which (ii) many applications and refutable implications accrue and in relation to which (iii) many empirical tests have been conducted and are broadly corroborative (Paul Joskow, 1991; Howard Shelanski and Peter Klein, 1995; Bruce Lyons, 1996; Keith Crocker and Scott Masten, 1996).

The institutions of principal interest to the NIE are the institutional environment (or rules of the game—the polity, judiciary, laws of contract and property [Douglas North, 1991]) and the institutions of governance (or play of the game—the use of markets, hybrids, firms, bureaus). Although it has been customary to work at one level at a time, each level informs the other, and recent work of a combined kind has appeared as applications to economic development and reform are attempted. Also, the study of economic institutions needs to make provision for two background conditions: the condition of societal embeddedness (to which sociologists refer; [Mark Granovetter, 1985; Victor Nee, 1997]) and the attributes of human actors (Herbert Simon, 1985; Leda Cosmides and John Tooby, 1994, 1996). I return to these two background conditions in Section II. Suffice it to observe here that the NIE is, by its very nature, an interdisciplinary undertaking.

## I. The Governance of Contractual Relations

Transaction-cost economics is located on the branch of the NIE that is predominantly concerned with governance, the branch that has its origins in Ronald Coase's treatment of firms and markets in his classic 1937 paper on ''The Nature of the Firm.'' Rather than take the organization of economic activity in firms and markets as preexisting, defined largely by technology, Coase described firms and markets as alternative means for doing the very same thing. The allocation of activity as between markets and hierarchies was no longer taken as given, but needed to be derived. Should a firm make or buy? Which transactions go where and why? The firm was reconceptualized for these purposes as a governance structure (which is an organizational construction).

Much of the predictive content of transaction-cost economics works through the discriminating-alignment hypothesis: transactions, which differ in their attributes, are aligned with governance structures, which differ in their cost and competence, so as to effect a (mainly) transaction-cost economizing result. Implementing this requires that transactions, governance structures, and transaction-cost economizing all be described. What are the defining attributes of transactions? What are the attributes with respect to which governance structures differ? What main purposes are served by economic organization? How is transaction-cost economizing accomplished?

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According to John R. Commons (1932 p. 4), ''the ultimate unit of activity ... must contain in itself the three principles of conflict, mutuality, and order. This unit is a transaction.'' Transaction-cost economics concurs that the transaction is the basic unit of analysis and regards governance as the means by which order is accomplished in a relation in which potential conflict threatens to undo or upset opportunities to realize mutual gains.

The problem of conflict upon which transaction-cost economics originally focused is that of bilateral dependency (Williamson, 1975; Benjamin Klein et al., 1978). Whereas the organization of transactions that are supported by generic investments is easy (classical market contracting works well because each party can go its own way with minimal cost to the other), potential problems arise when nonredeployable investments are made. Parties that are joined in a condition of bilateral dependency (by reason of asset specificity) and are confronted with contractual incompleteness (by reason of bounds on rationality) must confront strains (by reason of opportunism) when faced with the need to adapt cooperatively. How should such contracts be managed?

A comparative assessment of markets and hierarchies is needed. Taking adaptation to be the central problem of economic organization, of which autonomous and cooperative kinds are distinguished, markets enjoy the advantage in autonomous-adaptation respects, and the advantage shifts to hierarchies as the needs for cooperative adaptation build up. Discrete structural differences between markets and hierarchies in incentive intensity, administrative control, and contract-law regimes are responsible for these adaptive differences (Williamson, 1991).

Implicit in the foregoing and important to the transaction-cost economics enterprise is the assumption that contracts, albeit incomplete, are interpreted in a farsighted manner, according to which economic actors look ahead, perceive potential hazards, and embed transactions in governance structures that have hazard-mitigating purpose and effect. Also, most of the governance action works through private ordering, with courts being reserved for purposes of ultimate appeal. Furthermore, although vertical integration is the archetype transaction out of which transaction-cost economics works, labor, capital, corporate governance, regulation/deregulation, vertical market restrictions, multinational and public-sector transactions are variations on a theme to which numerous public-policy ramifications accrue. Finally, although bilateral dependency (asset specificity) is a widespread condition, the basic transaction-cost setup, with its emphasis on *ex post* governance, applies to contractual hazards more generally.

Additional hazards that transaction-cost economics has begun to address include (i) the hazards of weak property rights (David J. Teece, 1986); (ii) measurement hazards of multiple-task (Bengt Holmstrom and Paul Milgrom, 1991), oversearching (Yoram Barzel, 1982; Roy Kenney and Klein, 1983), and multiple-principal (Avinash Dixit, 1996) kinds; (iii) intertemporal hazards, which can take the form of disequilibrium contracting, real-time responsiveness, long latency, and strategic abuse; (iv) hazards that accrue to weaknesses in the institutional environment (North and Barry Weingast, 1989; Brian Levy and Pablo Spiller, 1994; Weingast, 1995), which are pertinent to economic development and reform, and (v) weaknesses of probity, which are of special concern for what James Q. Wilson (1989) refers to as ''sovereign transactions'' (see also Williamson [1998]). To be sure, lenses other than transaction-cost economics can and have been brought to bear. It is nonetheless noteworthy that transaction-cost economics relates to all of these hazards in the following four respects: (i) all of these hazards would vanish but for bounds on rationality and opportunism, (ii) the magnitude of the hazards varies systematically with the attributes of transactions, (iii) *ex post* governance (as well as *ex ante* incentive alignment) is an important instrument in effecting hazard mitigation, and (iv) the discriminating-alignment hypothesis applies. Hazard mitigation through the *ex post* governance of incomplete contracts is the general rubric.

Whereas organizational variety was once ascribed principally to monopoly purpose and/or efficient risk-bearing, much of this variety is usefully interpreted in transaction-cost-economizing terms. It matters a lot, as it turns out, whether firms are described as governance structures rather than production functions.

What came to be known as the ''inhospitality tradition'' in antitrust was the public-policy consequence of treating the firm as a production function (which is a technical construction). Because a technological justification for nonstandard and unfamiliar contractual and organizational practices was lacking under the neoclassical setup, such practices were presumed to be anticompetitive.

However, that is because the study of economics was needlessly truncated. Technological economies of scale or scope and related ''technical or physical aspects'' do not exhaust the possibilities. Organizational economies that are attributable to the alignment of governance structures with the attributes of transactions had been ignored or suppressed. Upon working through the logic of discriminating alignment, an altogether different rationale for vertical integration, vertical market restrictions, and other forms of nonstandard contracting took shape.

Many of the hitherto puzzling economic institutions of capitalism were interpreted more constructively as this broader approach to economizing progressed. Thus, although anticompetitive purpose remains a concern if the relevant market-power preconditions are satisfied, those are stringent preconditions. As a consequence, anticompetitive effect is better regarded as the exception rather than the rule.

The concepts of credible commitment and discriminating alignment that inform private-sector governance have also turned out to be instructive for understanding economic development and reform. Viewing the institutional arrangements (rules of the game) through the lens of contract and governance has helped, among other things, to disclose when and why privatization efforts will succeed or fail.

## II. Background Conditions

The two background conditions to which I referred earlier are the conditions of embeddedness and the attributes of human actors. The first of these is antecedent to the polity and refers to societal features (norms, customs, mores, religion) which differ among groups and nation states and operate as societal supports, or the lack thereof, for credible contracting. A recurring concern is when and why do reputation-effect mechanisms work well and poorly?

Turning to the attributes of human actors, Simon (1985 p. 303) takes the position that ''Nothing is more fundamental in setting our research agenda and informing our research methods than our view of the nature of the human beings whose behavior we are studying.'' The huge literature on ''psychology and economics,'' as recently summarized by Matthew Rabin (1996), speaks to many of the issues. Of special interest is research stemming from Daniel Kahneman and Amos Tversky (1982), in which the limits and biases of individual decision-makers in making probabilistic choices are revealed. Also pertinent are recent studies by cognitive anthropologists (Edwin Hutchins, 1995) and evolutionary psychologists (Cosmides and Tooby, 1996).

Hutchins's book on *Cognition in the Wild* makes the distinction between cognition ''in the laboratory, where cognition is studied in captivity, and the everyday world, where human cognition adapts to its natural surroundings'' (1995 p. xiv). Issues of organization are brought in by viewing individuals as ''part of a larger computational system'' (Hutchins, 1995 p. xv). Because, moreover, each generic form of organization has both strengths and weaknesses, organization needs to be studied as both problem and solution. Cognitive anthropology can help to inform both.

The evolutionary-psychology literature notes that cognitive methods ''drawn from logic, mathematics, and probability theory'' (Cosmides and Tooby, 1994 p. 319) and cognitive processes that had good survival properties for human agents operating in the Pleistocene sometimes differ. For example, framing problems of choice under uncertainty in frequentist terms, which is the manner in which they arise in the wild, rather than in point estimates, which is the way they are posed by statistical decision theory, is consequential. Cognitive biases and disabilities are often reduced when problems are presented in frequentist terms.

Evidence, moreover, that individuals on average are poor probabilists speaks only to the mean. If there is variance in the aptitude to make probabilistic choices among members of the population, and if it is cost-effective to screen for differential competence, then an efficient alignment of differential competence to tasks can be effected through specialization (organization). Not only does organization matter in this respect, but it also relieves problems of limited cognitive ability by permitting composite tasks to be broken down into nearly separable parts, each of which is more tractable, thereafter to be recombined (Simon, 1962). The upshot is that the study of individual decision-making needs to be extended to make provision for the efficient deployment of individuals and groups within an organization. Cognitive anthropology, organization theory, and evolutionary psychology are all implicated.

## III. Concluding Remarks

The papers and discussions at the inaugural conference of the International Society for New Institutional Economics in September 1997 record that the NIE continues to extend its analytical reach and inform new issues. New conceptual challenges arise as new applications are attempted. A deeper understanding of complex economic organization is in progress.

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