Contested Exchange Versus the Governance of Contractual Relations

Oliver E. Williamson

The Journal of Economic Perspectives, Volume 7, Issue 1 (Winter, 1993), 103-108.

Stable URL:
http://links.jstor.org/sici?sici=0895-3309%28199324%297%3A1%3C103%3ACEVTGO%3E2.0.CO%3B2-Z

Your use of the JSTOR archive indicates your acceptance of JSTOR's Terms and Conditions of Use, available at http://www.jstor.org/about/terms.html. JSTOR's Terms and Conditions of Use provides, in part, that unless you have obtained prior permission, you may not download an entire issue of a journal or multiple copies of articles, and you may use content in the JSTOR archive only for your personal, non-commercial use.

Each copy of any part of a JSTOR transmission must contain the same copyright notice that appears on the screen or printed page of such transmission.

The Journal of Economic Perspectives is published by American Economic Association. Please contact the publisher for further permissions regarding the use of this work. Publisher contact information may be obtained at http://www.jstor.org/journals/aea.html.

The Journal of Economic Perspectives
©1993 American Economic Association

JSTOR and the JSTOR logo are trademarks of JSTOR, and are Registered in the U.S. Patent and Trademark Office. For more information on JSTOR contact jstor-info@umich.edu.

©2003 JSTOR

http://www.jstor.org/
Fri Feb 7 22:07:53 2003

Journal of Economic Perspectives—Volume 7, Number 1—Winter 1993—Pages 103–108

Contested Exchange Versus the Governance of Contractual Relations

Oliver E. Williamson

There is much in the paper by Samuel Bowles and Herbert Gintis with which I agree. But there are also real differences—which is to be expected, since they and I examine economic organization through very different lenses. Thus whereas they view economic organization through the lens of power and contested exchange, I believe that economizing and governance is, for most purposes, a more productive perspective. I also have a variety of minor differences with their paper.

I begin with our agreements, next consider conceptual differences, and then run through the more minor matters.

Agreement

I agree that the "Walrasian fiction" to which Bowles and Gintis refer has impeded the study of economic organization. To be sure, the idea that economics could operate out of an "institution free core"[1] has inspired excellent work. Many economists are now persuaded, however, that the concerted study of institutional forms and functions is needed. Different questions from those

[1]The expression originates with Vernon Smith.

■ *Oliver E. Williamson is Transamerica Professor of Business, Economics, and Law at the University of California, Berkeley, California.*

posed by Walrasian general equilibrium theory, as well as by applied price theory, are being asked and answered.[2]

I also agree with the proposition that evolutionary processes are path dependent. That does not preclude comparative efficiency assessments of alternative feasible forms, but some forms may be privileged by their evolutionary origins.[3]

Their proposition that "Democratic firms may well exhibit hierarchical administrative structures" (p. 94) is also one with which I agree. Indeed, I would go further: very small groups excepted, all viable peer groups will employ hierarchy to make and implement operating decisions (as opposed to strategic decisions).[4]

Their view that preferences are endogenous is also one to which I subscribe. That can complicate matters very considerably, however, and for many problems is inessential. Workable simplifications are ones that we employ routinely. It often suffices to take preferences as given.

I further agree with their proposition that post-Walrasian economics pushes beyond conventional disciplinary boundaries. The combined study of law, economics, and organization is, I think, especially productive (Williamson, 1985, 1988a). Bowles and Gintis go beyond this to include "law, history, sociology, psychology, and politics." That is fine, but there is a need to combine these in a disciplined way.

Finally, I am pleased that they and I agree that "a critique of capitalism must be based on comparison with *feasible* alternative institutions" (p. 97; emphasis added). That important proviso should have appeared much earlier in their paper, however, and they should have taken their own advice. The claim that "only by great coincidence then would institutional evolution be allocationally efficient" (p. 87) immediately raises the question, as compared with what? And the associated claim that contested exchange markets "fail to implement socially efficient resource use" (p. 88) refers to a hypothetical ideal,

[2]"The New Institutional Economics movement—[does] not consist primarily of giving answers to the traditional questions of economics—resource allocation and degree of utilization. Rather, it consists of answering new questions, why economic institutions have emerged the way they did and not otherwise; it merges into economic history, but brings sharper nanoeconomic... ('nano' is an extreme version of 'micro') reasoning to bear than has been customary" (Arrow, 1987, p. 734).

[3]Much of the most widely cited example of path dependency is the QWERTY typewriter keyboard. Paul David's (1985; 1986) rendition of the history of QWERTY is widely interpreted as support for the proposition that path dependency is commonly responsible for the failure of later and superior technologies to supplant earlier and less efficient designs. S. J. Liebowitz and Stephen Margolis (1990) have subsequently examined the typewriter keyboard history, however, and argue that the speed advantage of the Dvorak keyboard is largely a myth. They conclude that the "most dramatic claims [of advantage] are traceable to Dvorak himself, and the best documented experiments, as well as recent ergonomic studies, suggest little or no advantage for the Dvorak keyboard" (p. 21). To be sure, the importance of path dependency is not going to be decided by how the typewriter keyboard controversy comes out. But there are two further points. First, we are still awaiting a demonstration that path dependency has large and widespread effects. Second, comparative efficiency analysis can and ought to take path dependency into account.

[4]There appears to be growing agreement with this assessment, although a curious schizophrenia runs through much of the peer group literature (Williamson, 1988b, pp. 174–76).

the feasible (operational) counterpart for which is not described. John Ray's proverb is pertinent: "If wishes were horses, beggars might ride."

Governance

Bowles and Gintis emphasize power and contested exchange whereas I contend that economizing and governance are more important. Although both approaches are informative, there is sometimes a need to choose. My suggestion is that each rival "main case" candidate be asked to show its hand: What is the logic out of which it works? What are the testable implications? What do the data support?

The logic of transaction cost economics has been set out elsewhere (Williamson, 1975, 1985, 1991; Klein, Crawford, and Alchian, 1978; Grossman and Hart, 1986) and has been applied to a wide range of phenomena—including vertical integration, vertical market restrictions, franchising, regulation, labor market organization, the organization of work, corporate finance and corporate governance, regulation and deregulation, family firms, multinational firms, and the economics of trust, among others. Furthermore, frequent claims to the contrary notwithstanding, transaction cost economics has been subject to numerous empirical tests—most of which are corroborative.[5]

To be sure, many of the tests are against a null hypothesis of zero effects. It would be more interesting to compare the implications of the economizing hypothesis with the power hypothesis out of which Bowles and Gintis work. Transaction cost economics invites comparison on those terms, but that requires that the implications of the power hypothesis be set out, which is their obligation.

Note in this connection that transaction cost economics maintains that contracts are triples in which price, asset specificity, and contractual safeguards are all determined simultaneously. *Price does not speak in isolation* but only in relation to contractual hazards and the associated safeguards. Specifically, contracts that pose hazards that are not mitigated by safeguards will be priced out differently than contracts where those same hazards are mitigated. If price, in commercial transactions, is merely an instrument for completing transactions, then what useful purpose is served by bold statements that "money talks" (p. 95)?

Relatedly, Bowles and Gintis refer to the need to think of the "institutions of capitalism as a means of simultaneously managing two central agency problems of the economy: work, and managerial decision-making, particularly concerning risk" (p. 97). I would suggest that labor, management, *and finance* need to be examined simultaneously. I would furthermore urge that

[5]See Williamson (1985, Chapter 5), Paul Joskow (1988; 1991), and Howard Shelanski (1991) for surveys of the empirical literature. Joskow avers that in many ways the empirical work in transaction cost economics "is in much better shape than much of the empirical work in industrial organization generally" (1991, p. 81).

governance structure differences between debt finance and equity finance should be sharply distinguished.

This last argument is elaborated elsewhere (Williamson, 1988c). Briefly, it comes down to the following: (1) easily redeployable assets are appropriately financed by debt, (2) highly nonredeployable assets are ones for which equity finance is more well suited, (3) the governance structure associated with debt is more legalistic and works out of rules while that associated with equity is more hierarchical and allows greater discretion, (4) the board of directors is a discretionary control instrument that is efficiently awarded to residual claimants—namely, equity in firms in which investments in durable, nonredeployable physical assets are significant, (5) refusal to award control over the board of directors in such firms to equity finance poses an investment hazard, the effect of which is to raise the effective price of finance, and (6) some firms—mainly professional firms (law firms, accounting firms, investment banking, consulting)—involve negligible investment in firm-specific physical assets and are appropriately organized as worker-controlled partnerships.[6]

Bowles and Gintis make no distinctions between types of finance and treat finance in power rather than efficiency terms. Thus they contend that "capital markets tend to penalize non-hierarchical enterprise structures" (p. 93), and they aver that "capital markets concentrate power because rational lenders *prefer* to transact with organizations with undemocratic political structures" (p. 94; emphasis added). I submit that competition for capital is ordinarily pervasive and that capital will move from one use to another upon the offer of a slight (risk adjusted) premium. Capital that is made available on terms that objectively reflect prospective returns (as adjusted for contractual hazards) is, in effect, devoid of "preferences."

Other

Bowles and Gintis contend that opportunism is indistinguishable from simple self-interest seeking. It was not so long ago, however, that opportunism was assumed away: standard "economic models [treat] individuals as playing a game with fixed rules which they obey. They do not buy more than they can pay for, they do not embezzle funds, they do not rob banks" (Diamond, 1971, p. 31). Indeed, the post-Walrasian world to which Bowles and Gintis call our attention differs from the Walrasian world precisely because individual economic agents (1) are subject to bounded rationality, hence all complex contracts are unavoidably incomplete and there are many missing markets, and (2) are given to opportunism, hence mere promises unsupported by credible commitments pose contractual hazards.[7]

Although I, like Bowles and Gintis, believe that trust is a good word, I contend that the growing tendency to use trust and risk interchangeably

[6] On this last, see Henry Hansmann (1988).
[7] For an elaboration, see Williamson (1985, pp. 64–67).

(Coleman, 1990, p. 91; Gambetta, 1988, p. 217) confuses rather than illuminates what economic organization is all about. The concept of "calculated trust" is a contradiction in terms (Williamson, 1993).

Bowles and Gintis characterize my efficiency position as follows: Williamson asserts that "the institutions emerging from the competitive process will be efficient or 'transaction cost minimizing'" (p. 97). That is too strong. I hold only that the institutions emerging from the competitive process will be *comparatively* efficient; and I eschew reference to minimizing and maximizing.

Thus whereas neoclassical optimization models typically (1) employ maximization and minimization techniques, (2) either ascribe hyperrationality to economic actors or work out of strong-form selection, and (3) include and are sometimes preoccupied with hypothetical forms of organization in which interesting institutional features are ignored or excised, transaction cost economics proceeds differently. It (1) examines alternative forms of organization that differ in kind (that is, in *discrete structural* rather than marginal respects), (2) ascribes farsightedness, but not hyperrationality, to economic actors and employs weak-form selection, and (3) examines only feasible forms of organization, the efficacy of which forms are assessed comparatively.

Weak-form selection is a comparative test: "in a relative sense, the *fitter* survive, but there is no reason to suppose that they are *fittest* in any absolute sense" (Simon, 1983, p. 69; emphasis in original). Even comparative efficiency is controversial. It is a productive research orientation nonetheless.

The hypothesis is advanced that—in the commercial sector and especially in the long run, when the Schumpeterian "handing on" process can be presumed to have taken hold—economic organization can largely be understood as an effort to align transactions with discrete structural modes of governance in a transaction cost economizing way. Applications of the argument to a wide range of phenomena yield a large number of predicted alignments (which alignments turn out to be variations on a few key themes). Those predictions invite comparisons with rival hypotheses and with the data. If that be maximizing or minimizing, so be it; but a radical transformation in optimization has occurred in the process.

As matters stand presently, the power hypothesis is typically vague and often reduces to an ex post rationalization—which explains James March's conclusion: "Power has proven to be a disappointing concept" (1988, p. 6). Although I seriously doubt that power qualifies for main case standing in the commercial arena, I agree that it can sometimes be brought in as an auxiliary hypothesis. The challenge then is to ascertain when, why, and with what effects. Also, power may have a lot more to say about the institutional environment than it does about the institutions of governance.[8] Rules of the game that privilege one group in relation to another for reasons that are lacking in merit

[8]The crucial distinctions are set out in Lance Davis and Douglass North (1971, pp. 6–7). For an effort to examine the institutional environment and the institutions of governance in a combined way, see Williamson (1991).

are insidious. Since, however, contested exchange is concerned with governance, that is another story.

■ *My thanks to Sam Bowles and Herb Gintis for stimulating and to Joe Stiglitz for orchestrating this exchange.*

References

Arrow, Kenneth J., "Reflections on the Essays." In Feiwel, George, ed., *Arrow and the Foundations of the Theory of Economic Policy.* New York: New York University Press, 1987, 727–34.

Bowles, Samuel and Herbert Gintis, "The Revenge of Homo Economicus: Contested Exchange and the Revival of Political Economy," *Journal of Economic Perspectives,* Winter 1993, 7:1, 83–102.

Coleman, James, *The Foundations of Social Theory.* Cambridge: Harvard University Press, 1990.

David, Paul, "Clio and the Economics of QWERTY," *American Economic Review,* May 1985, *75,* 332–37.

David, Paul, "Understanding the Economics of QWERTY: The Necessity of History." In Parker, W. N., ed., *Economic History and the Modern Economist.* New York: Basil Blackwell, 1986, 30–49.

Davis, Lance E. and Douglass C. North, *Institutional Change and American Economic Growth.* Cambridge, England: Cambridge University Press, 1971.

Diamond, Peter, "Political and Economic Evaluation of Social Effects and Externalities: Comment." In Intrilligator, M., ed., *Frontiers of Quantitative Economics.* Amsterdam: North-Holland Publishing Company, 1971, 30–32.

Gambetta, Diego, *Trust: Making and Breaking Cooperative Relations.* Oxford, England: Basil Blackwell, 1988.

Grossman, Sanford J. and Oliver D. Hart, "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration," *Journal of Political Economy,* August 1986, *94,* 691–719.

Hansmann, Henry, "Ownership of the Firm," *Journal of Law, Economics, and Organization,* Fall 1988, *4,* 267–304.

Joskow, Paul, "Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence," *Journal of Law, Economics, and Organization,* Spring 1988, *4,* 96–118.

Joskow, Paul, "The Role of Transaction Cost Economics in Antitrust and Public Utility Regulatory Policies," *Journal of Law, Economics, and Organization,* Special Issue 1991, 7, 53–83.

Klein, Benjamin, R. A. Crawford, and A. A. Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process," *Journal of Law and Economics,* October 1978, *21,* 297–326.

Liebowitz, S. J. and Stephen Margolis, "The Fable of the Keys," *Journal of Law and Economics,* April 1990, *33,* 1–26.

March, James, *Decisions and Organizations.* Oxford, England: Basil Blackwell, 1988.

Shelanski, Howard, "Empirical Research in Transaction Cost Economics: A Survey and Assessment," unpublished manuscript, Department of Economics, University of California, Berkeley, 1991.

Simon, Herbert, *Reason in Human Affairs.* Stanford: Stanford University Press, 1983.

Williamson, Oliver E., *Markets and Hierarchies: Analysis and Antitrust Implications.* New York: Free Press, 1975.

Williamson, Oliver E., *The Economic Institutions of Capitalism.* New York: Free Press, 1985.

Williamson, Oliver E., "The Logic of Economic Organization," *Journal of Law, Economics, and Organization,* Spring 1988a, *4,* 65–93.

Williamson, Oliver E., "The Economics and Sociology of Organization: Promoting a Dialogue." In Farkas, George and Paula England, eds., *Industries, Firms, and Jobs.* New York: Plenum, 1988b, 159–85.

Williamson, Oliver E., "Corporate Finance and Corporate Governance," *Journal of Finance,* July 1988c, *43,* 567–91.

Williamson, Oliver E., "Comparative Economic Organization: The Analysis of Discrete Structural Alternatives," *Administrative Science Quarterly,* June 1991, *36,* 269–96.

Williamson, Oliver E., "Calculativeness, Trust, and Economic Organization," *Journal of Law and Economics,* forthcoming 1993.