

**The Mechanisms of Governance:
Looking Back, Taking Stock,
Looking Ahead**

The Mechanisms of Governance: Looking Back, Taking Stock, Looking Ahead

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1. Applied Microeconomics in Crisis (1970)
2. Consequential Conceptual Shifts
3. Implementation
4. Challenges and Puzzles
5. Conclusions

But first: Joskow on *Transaction Cost Economics*

Joskow Publications Relating to Transaction Cost Economics

- "Vertical Integration and Long Term Contracts: The Case of Coal Burning Electric Generating Plants", Journal of Law, Economics and Organization, 1:1, Spring, 1985, pp 33-80.
- "Long Term Vertical Relationships and the Study of Industrial Organization and Government Regulation", Journal of Institutional and Theoretical Economics, December 1985, 587-593.
- "Contract Duration and Relationship Specific Investments: Empirical Evidence from Coal Markets", American Economic Review, 77:1, March 1987, pp 168-185.
- "Price Adjustment in Long Term Contracts: The Case of Coal", Journal of Law and Economics, XXXI, April 1988, pp 47-83.
- "Asset Specificity and the Structure of Vertical Relationships: Empirical Evidence," Journal of Law, Economics and Organization, IV:1, Spring 1988, pp.95-117.
- "The Performance of Long-Term Contracts: Further Evidence from Coal Markets," Rand Journal of Economics, 21:2, Summer, 1990, pp 251-274.

- "The Role of Transactions Cost Economics in Antitrust and Public Utility Regulatory Policies", Journal of Law, Economics and Organization, 7, 1991, pp 53-82.
- "The New Institutional Economics: Alternative Approaches", Journal of Institutional and Theoretical Economics, 151:1, March 1995, 248-259.
- "Introducing Competition into Regulated Network Industries: From Hierarchies to Markets in Electricity", Industrial and Corporate Change, 5:2, 1996, pp 341-382.
- "Asset Specificity and Vertical Integration", The New Palgrave Dictionary of Economics and Law, Peter Neuman, Editor, MacMillan, 1998 "Asset Specificity and Vertical Integration", The New Palgrave Dictionary of Economics and Law, Peter Neuman, Editor, MacMillan, 1998.
- "Transaction Cost Economics, Antitrust Rules and Remedies," Journal of Law, Economics and Organization, 18:1, April 2002, pp 95-116.
- "Electricity Sector Restructuring and Competition: A Transaction Cost Perspective," The Economics of Contracts: Theories and Applications, Eric Brousseau and Jean-Michel Glachant (eds.), Cambridge University Press, 2002.

- “Vertical Integration,” Handbook of New Institutional Economics, (C. Menard and M. Shirley, eds.), 2005, Springer.
- “Regulation and Deregulation after 25 Years: Lessons for Research,” International Review of Industrial Organization, 26: 169- 193, 2005.
- “Competitive Electricity Markets and Investment in New Generating Capacity,” The New Energy Paradigm (Dieter Helm, editor), Oxford University Press, 2007.
- “Regulation of Natural Monopolies,” Handbook of Law and Economics, A.M. Polinsky and S. Shavell, editors, Elsevier, 2007.
- “Incentive Regulation in Theory and Practice: Electric Distribution and Transmission Networks,” in Economic Regulation and its Reform: What Have We Learned? (N. Rose, ed.), University of Chicago Press, forthcoming.
- “New Institutional Economics: A Report Card,” New Institutional Economics, J-M Glachant and E. Brouseau, eds. Cambridge University Press, 2008.
- “Vertical Integration,” Issues in Competition Law and Policy, Wayne Dale Collins (ed.), Volume 1, Chapter 11, American Bar Association Section on Antitrust Law, August 2008.

Governance Defined

JLE (1979): A governance structure is:

“the institutional framework within which the integrity of a transaction is decided,” where integrity has reference to “soundness; avoidance of deception, expediency.”

OEW (Commons Triple of conflict, mutuality, and order):

“Governance is the means by which to infuse order, thereby to mitigate conflict and realize mutual gains.”

Others (as with Dixit (2009)) define governance mainly with reference to the rules of the game (the institutional framework) rather than the play of the game (as between the parties to a transaction, with emphasis on private ordering).

1. Applied Microeconomics in Crisis (1970)

1.1 The Resource Allocation Paradigm

The RAP was in 1970 and throughout most of the 20th Century the “Dominant Paradigm.”

All well and good for many purposes (esp. wrt prices and output, supply and demand), but not for all.

The perceived lapse in the economic theory of firms and markets (Coase, 1937): need to derive what was taken as given. Yet lapse continues 35 years later (Coase, 1972).

Basic tension: disconnect between theory and practice (Demsetz, 1983):

“It is a mistake to confuse the firm of [neoclassical] economic theory with its real world namesake. The direct mission of neoclassical economics is to understand how the price system coordinates the use of resources, not the inner workings of real firms.”

1.2 Positive transaction costs

Consequences of the assumption of zero transaction costs shown to be deeply troublesome:

Coase (1960) on “The Problem of Social Cost.” Poof.

Arrow (1969) on “The Organization of Economic Activity”:

... market failure is not absolute; it is better to consider a broader category, that of transaction costs, which in general impede and in particular cases completely block the formation of markets. It is usually though not always emphasized that transaction costs are costs of running the economic system. An incentive for vertical integration is replacement of the costs of buying and selling on the market by the costs of intrafirm transfers; the existence of vertical integration may suggest that the costs of operating competitive markets are not zero, as is usually assumed in our theoretical analysis.

1.3 Public policy toward business in 1960s overreaching.

- antitrust
- regulation

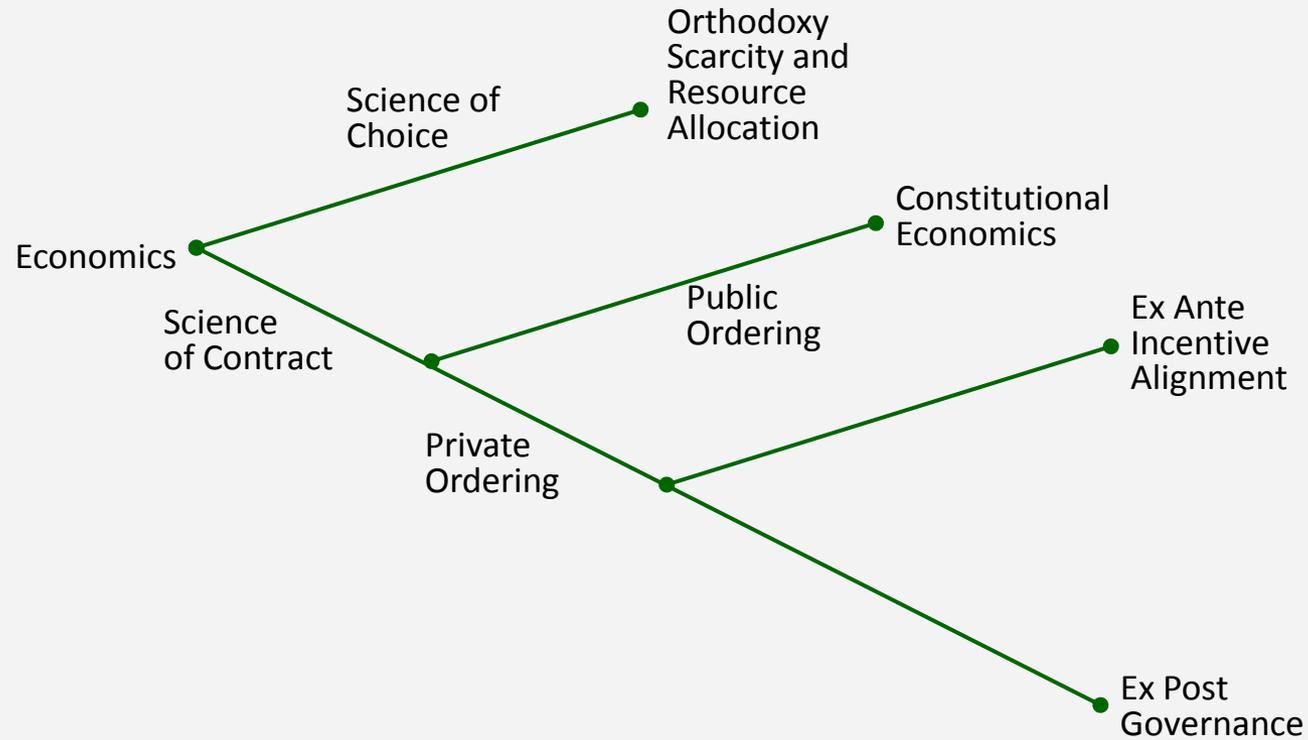
2. The Lens of Contract

2.1 The growing appeal of contractual reasoning:

Coase (1960). Reformulated the property rights (tort) problem in contractual terms. Remark: thinking contractually opens windows on a huge number of phenomena – many of which were viewed as settled by lens of choice reasoning.

James Buchanan avers that “mutuality of advantage from voluntary exchange is ... the most fundamental of all understandings in economics” (2001, p. 29). He further contends that this fundamental understanding is better realized by examining economics through the underused lens of contract rather than the overused lens of choice (Buchanan, 1975) – where, by the latter, he means the neoclassical resource allocation paradigm. Indeed, Buchanan (1975, p. 225) holds that economics as a discipline went “wrong” in its preoccupation with the science of choice and the optimization apparatus associated therewith. Wrong or not, the parallel development of a science of contract took time to develop and is still a work-in-progress.

Figure 1. The Sciences of Choice and Contract



2.2 The lens of contract/governance

Fortified by the positive transaction cost/lens of contract/organizational view of Coase, Arrow, Buchanan, and Carnegie, resolved to revisit vertical integration by applying the lens of contract to the make-or-buy transaction.

Implicit Conceptual Frame

- of course transaction costs are positive
- of course organization matters
- beyond spot markets to include long-term contracts (and embrace continuity)
- Of course contracts are incomplete
- Yet something is missing

(What is going on here?)

Remark: Organization matters for economists, if not more generally, if and as it is made susceptible to analysis

2.3 Consequential differences

Unease and criticism signal concerns but not bankruptcy. Theories (plural) rather than theory (singular). If a would-be theory is lurking, it needs to show its hand.

| Feature | Lens of choice (RAP) | Lens of contract/governance |
|---------------------|--|---|
| firms | black box | governance structure |
| analytical symmetry | firms and consumers (marginal) | firms and markets (discrete structural) |
| costs | production costs | transaction costs |
| contractual hazards | none (ideal transactions) | incompleteness/defection |
| adaptation | autonomous adaptation as "marvel of market" (scanted?) | central purpose - two types: - autonomous - coordinated |
| human actors | economic man described (convenience) | organizational man described (consequential) |
| institutions | institution-free core (e.g., contract law singular) | institutions matter (e.g., contract laws plural) |
| public policy | monopoly presumption | economizing presumption |

3. Implementation: General

“When I say that economics has not come to grips with implementation, I mean standard textbook economics” (Kreps)

3.1 John R. Commons

Of the many good ideas that originated with Commons, none was more important to the economics of governance than his abiding interest in “going concerns.” As against the preoccupation of orthodoxy with simple market exchange, Commons observed that the continuity of an exchange relationship was often important, whereupon he reformulated the problem of economic organization as follows: “the ultimate unit of activity ... must contain in itself the three principles of conflict, mutuality, and order. This unit is a transaction” (Commons, 1932, p. 4). Commons thereafter recommended that “theories of economics center on transactions and working rules, on problems of organization, and on the ... [ways] the organization of activity is ... stabilized” (1950, p. 21).

Although lack of a positive research agenda spelled the demise for older style institutional economics in the United States (Stigler, 1983, p. 170), this fate did not, imply an absence of good ideas.

Indeed, transaction cost economics subscribes to both parts of Commons' formulation of the problem of economic organization. Not only is the transaction the basic unit of analysis, but governance is the means by which to infuse order, hereby to mitigate conflict and realize mutual gains.

3.2 Unit of analysis

Going beyond naming a unit of analysis, there is a further (but frequently ignored) need: name the dimensions with respect to which the unit of analysis differs.

Transaction cost economics names the transaction as the unit of analysis. Dimensionalizing was greatly influenced by choice of a focal transaction and by temporality.

Focal transaction. Simplicity being the first precept of pragmatic methodology, analysis is facilitated by drilling into a specific transaction. Possible candidates include the employment relation, externalities, the intermediate product market transaction, the final product market transaction, the finance transaction, regulation, and the list goes on.

The two transactions that have been most often treated as focal are the employment relation (Coase, 1937; Simon, 1951; Hart and Moore, 2008; Hart, 2008) and the intermediate product market transaction (Williamson, 1971, 1979; Klein, Crawford, and Alchian, 1978). As between these two, the advantages that I associate with taking the intermediate product market transaction to be focal are these: (1) it is simpler; (2) the two parties to the intermediate product market transaction are more on a parity; (3) the key attributes of transactions and governance structures come more readily to the fore (example: the contractual condition of bilateral dependency, by reason of asset specificity (in its various forms) had hitherto been neglected); (4) the same is true of the interface differences between make and buy, in that attention is directed not to the contractual interface between individuals but to the contractual interface between successive stages of production; (5) this last has a bearing on scaling up from individual transactions to a series of technologically separable transactions; and (6) the regularities that arise in conjunction with the intermediate product market transaction also appear in many other commercial transactions, which are interpreted as variations on a theme.

Temporality. Upon taking adaptation to be the central problem of economic organization and distinguishing between autonomous (Hayek) and coordinated (Barnard) types, it is only natural to move beyond static optimality considerations to examine temporal differences between spot markets and incomplete long-term contracts. Contract duration aside, might process transformations, possibly with strategic considerations, set in? Bilateral dependency by reason of asset specificity would emerge as a contractual hazard for some long-term contracts. That would have pervasive governance ramifications.

3.3 Governance structures described

I will take as given that markets and hierarchies are described by a vector of three attributes: incentive intensity, administrative command and control, and contract law regime. With reference to contract laws (plural), I distinguish between a legal rules (court enforcement) contract law regime (which, for the RAP, was implicitly assumed) and forbearance law (where the courts refuse to grant standing).

Assuming that each attribute can take on either of two values, much (+) or nil (0), there are $2^3 = 8$ possible combinations. As among the eight combinations shown in Table 1. Which of these are internally consistent? Which define markets and hierarchies?

Table 1. Alternative Modes of Governance

| Incentive Mode | Incentive Intensity | Administrative Control | Contract Law Regime |
|----------------|---------------------|------------------------|---------------------|
| I | (+) | (+) | (+) |
| II | (+) | (+) | (0) |
| III | (+) | (0) | (+) :Market |
| IV | (+) | (0) | (0) |
| V | (0) | (+) | (+) |
| VI | (0) | (+) | (0) :Hierarchy |
| VII | (0) | (0) | (+) |
| VIII | (0) | (0) | (0) |

3.4 Interface differences

Going beyond the attribute differences shown in Table 1, do markets and hierarchies differ in interface respects not yet brought under purview? Specifically, what are the interface mechanisms that support autonomous adaptations in the market and coordinated adaptations in hierarchy?

Figure 2 applies.

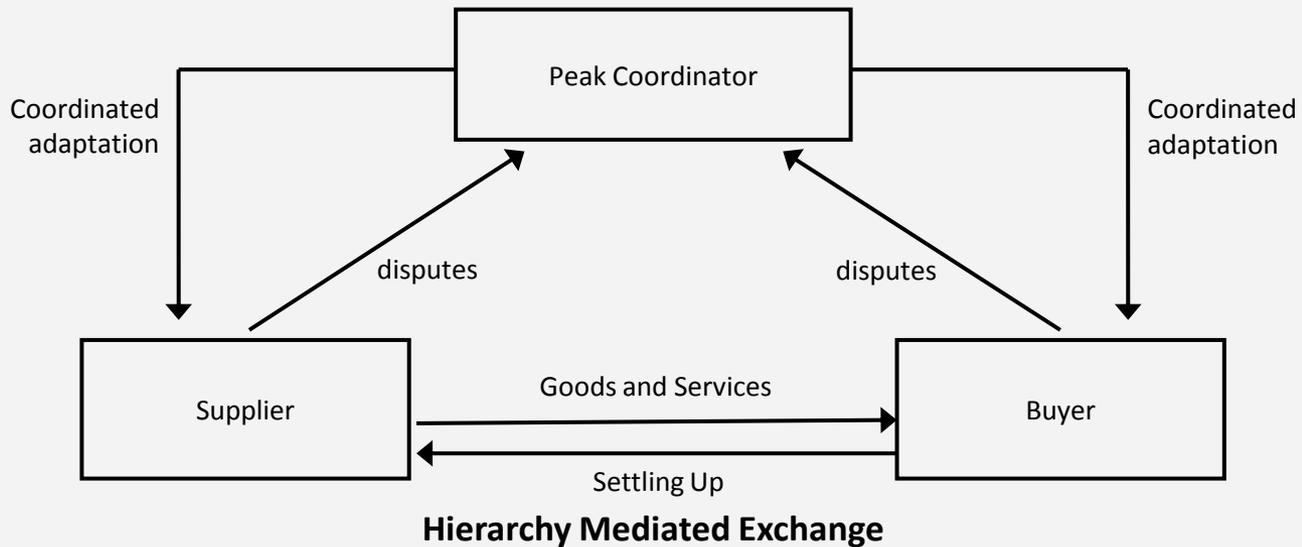
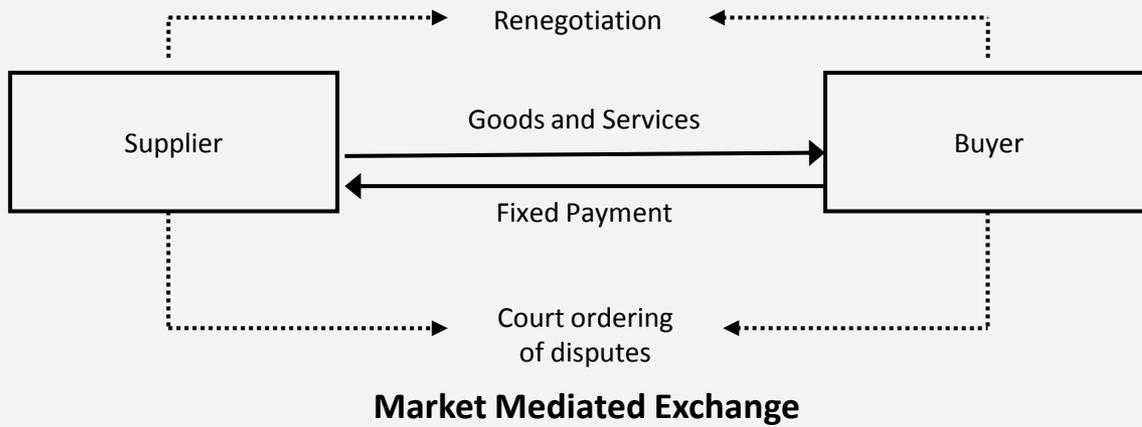


Figure 2. Interface Mediation

3.5 Refutable implications and empirical testing

The cutting edge for evaluating all would-be theories is that each is asked to make predictions to which the data are thereafter brought to bear. Nicholas Georgescu-Roegen had a felicitous way of putting it: “The purpose of science in general is not prediction, but knowledge for its own sake,” yet prediction is “the touchstone of scientific knowledge” (1971, p. 37). This is especially important in the social sciences where advocates of particular "viewpoints" (if not theories) often have strong ideological predilections. Faced with an impasse, prediction serves touchstone purposes.

Transaction cost economics predictions are derived from 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 yield a transaction cost economizing outcome.

Most economists know in their bones that theories that are congruent with the data are more influential. Friedman's reflections on a lifetime of work are pertinent: "I believe in every area where I feel that I have had some influence it has occurred less because of the pure analysis than it has because of the empirical evidence that I have been able to organize." There is no question that transaction cost economics is more influential because of the empirical work that it has engendered (Masten (1984); Joskow, 1988; Whinston, 2002; Macher and Richman, 2008).

4. Challenges

4.1 Variations on a theme

If any issue that arises as or can be reconceptualized as a contracting problem can be examined to advantage in transaction cost economics terms, then many phenomena should be interpreted as variations on the focal transaction. Experience has borne that out. Two are considered here.

Regulation. An early application of transaction cost economics was to the purported efficacy of franchise bidding for natural monopoly. Public policy toward business in the U.S. in the 1970s was polarized between the Harvard School, which was more interventionist, especially in antitrust, and the Chicago School, which was less interventionist, especially on regulation. Transaction cost economics differs from both.

Paul Joskow's reservations with the deregulation of electric power in California are pertinent (2002, pp. 527-528; emphasis added):

Electricity sector reforms necessarily must be built upon an infrastructure made up of long-lived historical sunk investments made over past decades. The investments were made within an institutional environment which did not contemplate the kinds of opportunism, coordination, and market power problems that can emerge in a decentralized system with many independent firms owning and operating different pieces of an industry. Market power problems, network congestion management, and coordination problems arising from restructuring of the existing configuration of assets should be expected and their existence carefully identified ex ante as an integral part of the design and implementation of liberalization reforms. Accordingly, electricity restructuring programs need to consciously and carefully include transition mechanisms to mitigate these problems until investments in new generating and transmission capacity can be made to move the system toward a new asset configuration that is less susceptible to them.

These mechanisms will include contracts to deal with local market power problems, carefully structured congestion management protocols and rules for injecting and withdrawing power from the grid, and transitional contracts between generators and those entities responsible for procuring power for retail consumers that both protect consumers from exploitation and diminish incentives that generators may have to exercise market power. These transition mechanisms must be put in place at the outset of the restructuring program because they are difficult to implement *ex post*, after problems emerge, since incumbent interests are likely to have a strong stake in preserving the status quo.

To be sure, there are some cases for which deregulation is an easy call and easy to implement. Electric power is an industry where the issues need to be worked through in a “modest, slow, molecular, definitive way.” More generally, transaction cost economics can often inform the not-so-easy cases.

Rainmakers. This is a rough and conjectural use of transaction cost reasoning and, at the very least, needs to be qualified. Be that as it may here it is:

The Oxford International Dictionary defines rainmaker as a "medicine man who uses incantations and magic rituals for the purpose of producing rain." Interestingly, the term has come to be applied more generally to individuals who are perceived to generate considerable income for the firms that employ them – especially lawyers in law firms, fund managers in financial firms, and some consultants.

That appears to be far removed from the intermediate product market transaction. The focal transaction nevertheless relates to commercial rainmakers in two respects. The first and most important is with reference to the absence of asset specificity. The second is to the "magical powers" that are ascribed to some rainmakers but are often a manifestation of opportunism – which comes as a “surprise” akin to thinking the unthinkable (even though a wary public, experienced politicians, and political commentators should know better).

Transaction cost reasoning thus interprets rainmakers as individuals (teams) that possess the following attributes: (1) the individual (team) is perceived to be exceptionally competent and has little human specific capital in the firm; (2) the firm is a professional shell with little physical, site specific, or dedicated assets in supplying services to clients; and (3) the rainmakers, the incumbent firm for which the rainmakers work, and their rivals can all make a good estimate of the stream of earnings that each rainmaker group generates. Rainmakers, in such circumstances, can demand to be paid a large fraction of their respective earnings streams under the credible threat they can leave, take their clients with them, and be paid "full value" elsewhere. Settling up by the payment of large bonuses at the end of the accounting year is thus understandably observed for rainmakers who have developed reputations for excellence with their clients (and interested potential clients) – although one year is an arbitrary accounting interval.

4.2 Scaling up

A challenge that pertains to all contractual theories of the firm is: does the toy model scale up?

Toy model is not used pejoratively. It is a crucial simplifying device. To question, however, whether the toy model informs the modern corporation is altogether legitimate.

Three influential toy models plus transaction cost economics come under scrutiny in this respect.

Jensen and Meckling(1976). Does the entrepreneurial model scale up to describe corporate governance in the modern corporation, or do these differ in kind?

Alchian and Demsetz (1972). Does the condition of technological non-separability out of which they work up scale up?

Grossman and Hart (1986). Does directional integration (which is not the integration interface shown in Figure 2) scale up?

Transaction cost economics. Does successive application of the make-or-buy calculus to a series of separable transactions scale up?

4.3 Full formalization

Many theories undergo a natural progression from informal to pre-formal to semi-formal to fully formal theories.

Some theories can also be described as prematurely fully formal, although that depends on the use to which they are put. Fully formal theories that are disjunct from the real world yet serve to fashion tools and open up new research horizons which inspires subsequent research from which predictions can be made and empirical tests performed are unarguably instructive.

Transaction cost economics, as described here, is at a semi-formal stage of theory development – although Tadelis and Williamson hope to move it up a notch.