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A New Push in the Theory of Organization A Commentary on O. E. Williamson's Comparison of Alternative Approaches to Economic Organization

by

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"Transaction cost economics stands to benefit from the infusion of greater organizational content. More generally, economics should both speak and listen ..."
(WILLIAMSON [1985, 402])

1. Introduction

The field of organization studies has had a large push in the last fifteen to twenty years, and Williamson's work is certainly one of the major driving forces behind this rapid development. The property rights approach and agency theory have both profited from Williamson's reasoned insistence on the importance of incomplete contracting, and his approach has also influenced sociological and legal studies on organizations. His books *Markets and Hierarchies* [1975] and *The Economic Institutions of Capitalism* [1985] are probably the most influential readings in the field of organization studies today.

Williamson observes an increasing integration of the various contractual approaches and he ventures the hope that the "elusive 'science of organization' ... may eventually take shape." (WILLIAMSON, [1990, 69]). This hope may be justified, but in all likelihood the elusive science of organization needs a *new push* in order to materialize and that push can only come from the willingness to link the general theorizing to more specific theorizing and the latter to empirical research.

Williamson is quite unusual among economists in that he is willing to bring in many aspects from other disciplines, including "a sense of justice", "human dignity", and Weberian characterizations such as "calculative relations". But he is quite true to the economists' tradition by exploring avenues mainly by enriching from case to case the core idea with suitable, plausible assumptions, as required to make a point, rather than to make work of the additional assumptions and to instigate research. The discussion of the internal labor market in the 1975 book (and its curious absence in his 1985 book) is a case in point. Why does he work this way? Isn't he interested mainly in substantive links when he states that "whereas physical scientists (and some economists) ask 'What's the law here', transaction costs economics is preoccupied with 'What's going on here?'" His own description is easily misleading, because he owes his success to the fact that his theory is able to drive the investigations, and in order to do that it needs to be quite abstract. "A central thesis of this book (i.e., *The Economic Institutions of Capitalism,* S.L.) is that a common theory of contract applies to transactions of all types . . ." [1] The specter against which he may want to safeguard himself might be the fate of the "old" institutional economics (Commons) which probably did not succeed because it gave up the "theory driven investigation" in favor of substantive enrichment.[2]

2. The New Convergence

There is an apparent dilemma: the success of the transaction costs approach relative to the "old" institutional economics is due to the fact that the transaction costs approach is theory driven. A theory that is richer in assumptions and closer to the messy reality is itself so much tailored to a particular selection of phenomena that it ceases to guide research on a great *variety* of phenomena. Thus, if one wants to hold on the theory-guidedness of research, one has to pay a price of keeping the theory fairly abstract, confine oneself to ad hoc enrichments, and leave the admittedly important task of dealing with the *messy* reality to, say, sociologists.

It is my central thesis in this commentary that this dilemma is decidedly dated. It was based on the old division of labor between economics (clean models) and sociology (messy reality), but that division has been vanishing rapidly in the last twenty years (cf. LINDENBERG [1985]). The rapid process of convergence between the two disciplines creates an entirely new situation: the models of men, and thereby the bases of theorizing, in the two disciplines are also rapidly converging toward something like the *homo socio-economicus,* handily dubbed RREEMM [3] (an acronym for resourceful, restricted, expecting, evaluating, maximizing man). Each element in this acronym is an open invitation to produce further explicit assumptions. For instance, the circumstances under which resourcefulness takes the form of opportunism (or other forms)

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[1] WILLIAMSON, [1985, 241]. One can also observe that the core idea became more compact over the years, as can be seen from a comparison of "idiosyncratic experience" in his 1975 book with "asset specificity" in later publications.

[2] See also DE ALESSI [1983]. Williamson may have detected a similar specter in (traditional) sociology where many substantive links have been investigated but rarely guided by theory.

[3] MECKLING [1976] suggested REMM and LINDENBERG [1983] completed the acronym with "restricted and expecting".

need to be specified; assumptions about the circumstances that especially limit the generation of adequate expectations and evaluations, i.e. about the extent of the boundedness of intentional rationality, need to be made. Irrespective of the particular specification of RREEMM, "rational man" entered for the first time a discipline that was rich with traditions of empirical research and rich with insights that had not been theoretically integrated due to the paucity of role-playing man as a theory of action. And in economics, various shades of uninhibited resourcefulness and of bounded rationality could be assumed, depending on context. Due to this convergence, the two disciplines can become useful to each other in quite different ways than before. The issue is *not* anymore whether one uses an efficiency framework or a power or socialization framework. The issue is that in both disciplines, the efficiency framework is clearly applicable at the individual level but that additional assumptions need to be made when the efficiency framework is extended to the collective level because then theoretical assumptions about evolutionary selection are necessary. Comparative institutional analysis must elaborate these assumptions.

3. The Method of Decreasing Abstraction

In this short commentary, it is not possible to go into a detailed description of new possibilities for theory formation created by the new convergence. But there is room to mention three clusters. The first cluster can be captured under the title of *the method of decreasing abstraction.* This method has been at home in economics for quite some time and it made especially microeconomics into a powerful analytic tool. It is the method of building a model in successive stages, such that some simplifying assumptions are replaced at each stage by less abstract (i.e. less simplifying or more concrete) assumptions. For example, in a beginning stage, it might be assumed that all individuals involved are perfectly informed and at a later stage, this assumption is relaxed. The idea behind this method is that a model should be as simple as possible and as complex as necessary and that one doesn't really know before how complex one has to get.

Due to the old division of labor between sociology and economics, the method of decreasing abstraction was first of all only used in economics; secondly it was not really used to develop a model in successive stages so close to reality that, say, additional concreteness would have been a waste of effort (say in measurement costs for extra parameters) in comparison to its return (say, increased explained variance). Sociology was assigned the messy reality and in economics, there was a widespread conviction of having access to a kind of superior grasp of the *general* reality that was revealed by the fact that even highly simplified neoclassical models could guide investigations in very different areas. Thus, there was no need in economics to get too close to the messy reality by successively more realistic models. Now that the old division of labor has gone, the method of decreasing abstraction appears in an entirely new light: it has to span the whole distance, from "as simple as possible" all the way to "as complex as necessary", both in economics and in sociology. Both have to get used to the situation. Sociologists have to unlearn their knee reflex of beginning with the most complex story (a strategy that had been rewarded for more than a hundred years), and economists must learn to make their story more complex (something they have not been rewarded for in more than a hundred years). Adding plausible assumptions to the core idea as one sees fit must be confined to the early stages of model development. In later stages, the "bridge assumptions" that make the model more concrete must themselves be measured against the state of the art concerning that area of discourse.[4] For example, one can learn something about certain efficiency features implied by the model that is being developed by tracing certain consequences without the effect of any deviation from risk neutrality (see WILLIAMSON [1985, 388 ff]). But eventually, theory and empirical research on risk for the relevant actors in the model must be referred to when making the assumption.

4. Framing Effects

The next new possibility that opened up due to the new convergence is attention to the question how core insights of both disciplines fit together. Most prominent in this respect is the confrontation of the importance of relative prices (and of scarcity) with the importance of the definition of the situation[5], resulting in the modeling of rational choice with framing effects. A situation is framed by a goal (and the relevant goal criterion) in the sense that that goal will select the relevant alternatives and thereby "define" the situation. Other utility arguments play at that time only an indirect role by influencing the firmness of the grip the frame has on the definition of the situation. If it were not for framing effects, the agency problem would be sometimes much easier to solve (when the frame is right) and sometimes much more difficult to solve (when it is not right) because strong frames make people act single-mindedly in given situations. This may be illustrated by a manager who thinks first and foremost about his career and guides his investment decisions with a view to maximizing his human capital returns. Depending on various circumstances this may or may not

[4] This may also shed some light on the controversy between neoclassical economists and "behavioral economists" (see EARL [1988]). The latter react to the change in the position of economics (due to the change in the division of labor with sociology) by insisting that economic theorizing becomes more realistic, in my view wrongly identifying the method of decreasing abstraction as restricted to the use economists had so far made of it. Yet, the research done by behavioral economists often provides relevant knowledge on bridge assumptions, so that even a wrong methodological assessment of economics can be useful.

[5] This confrontation has been described in some detail in LINDENBERG [1989a].

coincide with maximizing the value of the firm (see also HOLMSTRÖM and TIROLE [1989, 95]). If it does not, then framing will make it very costly to change the manager's behavior since the frame is not readily dislodged, and firing the manager will be costly because of his firm specific human capital.

Due to the method of decreasing abstraction, framing effects may be ignored for a while in the development of the model because a similar effect can be achieved by assuming (ad hoc) that a particular actor has only one major goal. But eventually, the assumptions on relevant utility arguments of the actors must be based on theory and research in the area of discourse, a particularly pertinent point in the next section.

5. *Social Production Functions*

In the old division of labor, preferences were assumed to be "given" in economics, and sociologists (and sometimes psychologists) were expected to say something about these "givens". Again, with the new convergence, this arrangement had to go. The most prominent reaction to this new imperative came from Gary Becker, who devised a way to let preferences appear entirely in an instrumental context whereby they can be explained as part of the social structure and thus as part of the given constraints. He and Stigler (see STIGLER and BECKER [1977]) accomplished this feat by the assumption of two kinds of preferences: *universal* preferences (goals) that are identical to all human beings and therefore need no explanation, and *instrumental* preferences for the means that lead to the ultimate goals which are in fact constraints and can thus be explained in a constraint driven approach. There is only one utility function for all mankind but there are systematically different production functions for different kinds of people. Buying a particular good is now not an act of consumption but the purchase of a means of production, such as a record for the production of music pleasure.

This approach fits nicely into the methodology of decreasing abstraction, because the specification of production functions can be seen as providing bridge assumptions about instrumental preferences. However, without a specification of what the ultimate goals are, the old danger of ad hoc theorizing looms large and little has been gained. For this reason, Becker's approach was further developed into what may be called the "social production function approach" (see LINDENBERG [1984], [1986], [1989a]). Following a lead from Adam Smith, and on the basis of relevant research, it was assumed that there are at least three ultimate goals: physical well-being, social approval, and the avoidance of loss. They are aspired by everybody, and therefore the means people have to reach these goals are of utmost importance to them, so important that a systematic threat to these means may cause a revolution (see LINDENBERG [1989b]). These means vary with social position and, together with the respective goal, they are called "social production functions".

The standard task in any explanation that involves individual actors is to specify the relevant social production function(s), especially the one on social approval. There is really only a very incomplete view of transaction costs and the agency problem in an internal organization without knowing what task definition has what kind of consequences for the production (or destruction) of social approval. In this way, the design of the task structure in the internal organization is intimately related to the creation and mitigation of transaction costs.[6] Williamson had something of this kind in mind when he referred to the resistance of some individuals to metering and he scolded Alchian and Demsetz for wrongly believing that "metering intensively, where this is easy (costless), has no effect on the attitudes of workers with regard to transactions that are costly to meter." (WILLIAMSON [1975, 55f]). And he also maintained that careful crafting of the governance structure is necessary, the more so the higher the human asset specificity (WILLIAMSON [1985, 242]). But he does not ever use these points again in a systematic way. By the same token, he does not make much use of his own distinction between perfunctory and consummate cooperation. The damaging consequences of perfunctory cooperation are due to incomplete contracting, so that going strictly by the rule misses all the unspecified features of the task. Thus, if metering reduces status, perfunctory cooperation may be the result. On the basis of social production functions we would not expect the status reducing feature of metering to be an idiosyncratic state but a predictable response of certain categories of people. For this reason, the link of social production functions to, say, the metering problem is theoretically and empirically tractable. We also know that metering by certain performance standards is not only not status decreasing but becomes part of the social production function. Here metering lowers information costs on what actions provide social approval, allowing the incorporation of these actions into the social production function.

A similar importance has to be attached to the motivating power of loss. Due to a framing effect, loss management can become the overriding goal of action with the added feature that, because of framing, the costs incurred in the loss management may be objectively higher than the objective value of the loss (which was incurred in a different frame). For this reason, people can react quite strongly when they feel treated unfairly or cross and when they lose face. Entitlement expectations that are generated by certain governance structures (such as "an honest day's pay for an honest day's work", or seniority pay raises in an internal labor market, or invertability of symbolic hierarchy by making somebody with considerably less education supervisor of somebody with con-

[6] HOLMSTRÖM and MILGROM [1990] see a different but possibly related relationship of task structure to the agency problem. In this context, it is also interesting to point to an observation by HOLMSTRÖM and TIROLE [1989, 104f] on how wrong the assumption of a goal (like maximizing the firm's size) can be when the relevant production function has not been specified, because such reduced forms are not robust to structural change.

siderably more education, etc.) will in all likelihood create a downwardly sticky status quo because of the strongly motivating power of loss. Clearly, private orderings are limited by this effect (demotions are difficult if not impossible, so is reduction in pay). Similar effects can be expected from negotiation with members of an unfamiliar culture. Again, WILLIAMSON [1975, 25] points to some relevant factors that produce or inhibit perfunctory cooperation, including efficient codes and convergent expectations but little ever happens with these observations in his further work.[7]

The more a task requires intelligent effort by an agent, the more the principal will depend on the good will of the person, and the more the governance structure will have to incorporate effects of social production functions. The damage potential of perfunctory cooperation (even for short periods of occupancy of such a position) may be so large that no asset specificity is needed to require fine tuning of governance structure with regard to social production functions. Take the following three effects for which there are actually indications: a) task structures that demand individual intelligent effort increase with technological development; b) the work force transfers more and more social approval expectations from the home to the working place; c) the law regulates increasingly the exploitation hazards of employees irrespective of the particular governance structure (reducing private ordering on this point). Any governance structure, no matter what else it regulates, would have to account for these three facts which jointly imply an overall increase in weak solidarity in selection, contrasting contract execution and conflict regulation (see LINDENBERG, [1988]). The theory would have to consider such effects, even if they are not likely to occur in inter-firm contracting but mainly in internal organization. There is no way to consider such effects seriously than to specify the theory for particular areas and instigate empirical research.

6. Conclusion

Williamson's work is at the cutting edge of organization studies. What will the next push in this field be? My answer to this question is that what is needed most is a specification of transaction costs theory in various areas in such a way that the specification is state of the art relative to the area of discourse and that the specified theories will be tested.

The old division of labor between economics and sociology created an apparent dilemma regarding the integration of theory and research: it seemed as if one had to choose between relatively simple models that are quite far removed from the messy reality but that have the advantage of guiding investigations

[7] See SPANGENBERG [1989] for an interesting application of some of Williamson's lose conjectures into a more coherent whole.

into a great variety of phenomena, versus being quite realistic in one's description but losing the power to guide research in different areas. Seemingly, Williamson is still captured by this way of looking at the situation. However, the old division of labor between economics and sociology has been eroded in the last twenty years and replaced by a process of convergence (with an yet non-negotiated division of labor). It is this process of convergence that allows the next push in the field of organization studies without the old dilemma.

Three examples of the new possibilities that are created by the convergence are briefly discussed. First, there is the method of decreasing abstraction that allows model building in stages of ever more realistic models without loss of the research guiding capacities of the simpler versions of the model. Second, there are framing effects that capture the joint effects of rational choice (economics) and the definition of the situation (sociology); these effects can make for a rather single-minded pursuit of goals which clearly affects transaction costs and agency problems, not just but mainly in internal organizations. Third, there are social production functions for general human goals. These allow the incorporation of instrumental preferences into the analysis in the form of social production functions that specify what conditions an individual considers vital for the production of social approval, physical well-being, and the avoidance of loss. These aspects greatly narrow the range of possible governance structures and, due to some observable trends, it is likely that different governance structures converge because they all have to maintain weak solidarity (i.e. a solidarity that does not lead to strong group boundaries and therefore to new transaction costs).

Finally it should not go unmentioned that the very topic of contracting has really come to the fore due to the new convergence between economics and sociology. In neoclassical economics, contracting was no problem because everybody was completely informed, and complex contingent claims could easily be drafted. In traditional sociology, contracting was no problem because people only acted in roles and they were socialized to observe the norms not specified in contracts. Only by the convergence to a joint model of man (to homo socio-economicus) it was possible to be confronted with extreme resourcefulness of people (i.e. opportunism), various shades of intentional rationality and framing effects in contracting, creating the fascinating basis for the elusive science of organization.

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