Rational and moral action: a critical survey of rational choice theory

de Jonge, J. P. R.

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CHAPTER IX

MICRO-INSTITUTIONAL THEORIES

1. Introduction

The second approach to invisible hand theories emphasizes the role of social institutions to regulate, coordinate and facilitate transactions. These institutions are thought to have emerged and evolved spontaneously as the unintended consequences of repeated transactions between independent agents. Though they probably emerged spontaneously, once these institutions became accepted they were further articulated and formalized. Social institutions embody shared social rules which instantiate commonly held beliefs about the behavior of agents. By knowing and following social rules, agents can establish stable expectations about how the actions of agents in manifold situations.

The attempt to explain how a stable and efficient social order could emerge spontaneously has, after the demise of the old institutional theory, been undertaken by the new
micro-institutional school, whose founding father is Coase. The micro-institutional theory is seen by its adherents as more than a marginal note on general equilibrium theory, and is promoted as an alternative of it. But the varieties of micro-institutional theory remain, despite their criticism of neo-classical theory, within the neoclassical tradition.

The accomplishment of the micro-institutional theory is in my view not that it analyzes how economic activities are socially or institutionally embedded. As an institutional theory it is inadequate, because it uses the concept of institution indiscriminately. Its strength is that it offers an explanation for the observed pattern of coordination at the micro-level within the economic system, and, in particular, why certain activities are coordinated in different ways (especially, markets versus firms). For Coase, issues such as these are at the heart of economic analysis.

Coase also studied the problem of social costs. He pointed out that alternative mechanisms of coordination at the micro-level entail different levels and patterns of costs. Understanding the import of these costs is central to understanding how and why coordination at the micro-level matters.

Coase laid the foundation for micro-institutional theories. Due to his pioneering work several schools have been established, such as the property rights school (Alchian and Demsetz) and transaction cost theory (Williamson) that are part of a collective effort to establish a Micro Institutional Theory in Economics and neighboring disciplines. Associated approaches are the school of Law and Economics (Posner) and Constitutional Theory (Buchanan). These schools have in common that they investigate the relation between allocative efficiency and ‘governance structures’ and employ concepts like property rights and transaction costs. In spite of the attempts to establish a new general institutional approach we can, however, observe that these schools have proceeded in different directions. The explanation of the emergence of two theoretical approaches, which have found their origin in the property rights school and transaction costs theory
respectively, will be an important subject of this chapter.

Another question I shall address is the definition of institutions in these micro-institutional theories. In the conclusion to this chapter I will raise the question whether the micro-institutional theories can be considered to be institutional theories at all.

I propose to start with the source where it all began. That is, to turn to Coase, who, with two seminal articles “The nature of the firm” in 1937 and “The problem of social cost” in 1960 laid the foundation for the micro institutional theories.138

2. Transaction costs and externalities

In “The nature of the firm” Coase poses the question: ‘Why do firms exist?’ Why do rational actors enter into hierarchical relations and trust the coordination of their actions to a central authority? Why don’t they rely on free exchange and automatic coordination through the market?’

The distinctive characteristic of the firm, according to Coase, is that it replaces the market mechanism. In his opinion, allocation through the market and allocation within a firm are two alternative methods to coordinate production. What has to be explained, therefore, is why one integrating force (the entrepreneur) replaces the other integrating force (the price mechanism). The reason must be that costs are involved in using the price mechanism.

To get an impression of these costs one must imagine that independent producers conduct all productive activities and that customers have to negotiate separately with each producer who manufactures components for the final

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138 These articles reappeared in Coase, 1988. Quotations refer to this book.
139 Dahlman (1979) proposed the following categorization of transaction costs: a) the costs connected with the search for and the acquisition of information concerning the quality of delivering goods and services; b) the costs connected with deciding and negotiating and c) the costs involved with the surveillance on the observance of contractual agreements.
product. Huge cuts on transaction costs can be realized were these producers to cooperate as a team under the leadership of an entrepreneur. Customers only need to negotiate with this single person who hires the factors of production and coordinates them. The producers, also, do not have to enter into contracts continuously. These contracts can be replaced by a single contract in which the producer: “(..), for a certain remuneration (..) agrees to obey the directions of an entrepreneur within certain limits.” (Coase, 1988, 39) Further economizing on transaction costs can be realized by closing contracts for a longer period, in which a general level of performance is agreed to. The details about specific performances are put in later. “A firm is likely, therefore, to emerge in those cases where a very short term contract would be unsatisfactory.” (Coase, 1988, 40)

Transaction costs are closely related to the costs of exchange. Not only the exchange of consumer goods, but also of intermediate goods, investment goods, raw materials etc. One can economize on the transaction costs by bringing all the activities needed to produce final goods (and services) together in a firm.

Coase argues strongly in favor of a comparative analysis in which the allocation by markets and by firms is compared on the basis of the transaction costs that are involved. On the level of the economic system the implication is that the ideal mix of firms and markets determines allocative efficiency. The allocative equilibrium is found at the lowest level of the inevitable transaction costs (given the institutional environment).  

As a result of this article a debate emerged about the precise nature of the firm. Is a firm indeed characterized by an authoritarian structure in which the entrepreneur coordinates

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140 This looks like a matter of fact, but what is efficient under the condition of one specific institutional environment, may have little or no bearing on what is efficient within a quite different institutional setting.
the activities of all members and the firm acts as a collective actor? Or is a firm a 'legal fiction', a vehicle for promoting the separate interests of the participants? In this case the distinction between markets and firms would become superficial.

In “The problem of social cost” Coase analyzed the phenomenon of (negative) externalities. Coase was targeting the Pigovian approach that argued that the divergence between private and social costs could only be cured through appropriately specified taxes, subsidies or regulations. Coase showed that, under the standard neo-classical assumptions regarding the operation of markets, the Pigovian remedies are, in fact, unnecessary. The argument is that the more valuable activity will -if necessary- buy out the legal entitlements of the less valuable activity. He demonstrated in this way that frictionless markets (markets without transaction costs) will efficiently resolve externalities. Stigler coined this as the “Coase Theorem”, which he defined as: ‘under perfect competition private and social costs are the same’. This theorem immediately attracted much attention, both positive and negative, due to its implications. The first is that an intervention of the government to solve conflicts about externalities is unnecessary. A simple assignment of rights suffices to solve the conflict in an efficient way through negotiations between the parties involved. What might traditionally be equated with market failures turns out to be a failure of the law to specify rights. A further implication is that no matter to whom rights are initially assigned, these externalities will be resolved. This conflicted with the prevalent view among legal scholars, who assumed that there is always an offender (e.g., a polluter) and a victim. (Medema, 1999, 217)

The point of departure for Coase in judging external effects is that there are always two parties involved, both of which possess (property-) rights. The manufacturer whose firm pollutes the air, has the right to produce and should, when this right is redefined (production is allowed under the
proviso..), be compensated. The people who live in the neighborhood of the factory have the right that their health is not affected by some entrepreneur’s activities. The problem always is whether A may cause damage to B or whether B may cause damage to A. The solution is to avoid the most serious damage. Given the reciprocal nature of externalities, the efficient solution is not simply a matter of internalizing costs, but whether and how costs should be internalized. Coase’s opinion was that when rights to execute certain actions can be bought and sold, that person for whom they represent the highest value would acquire them. When actors are rational, the negotiations costless and when there are no legal barriers against negotiations, then these transactions will be carried through to the point at which further negotiations cannot improve the situation and an optimal allocation is achieved. Thus, the “Coase theorem” amounts to the assertion that the legal allocation of rights is not relevant, because the market will in the end determine the actual allocation, on the precondition that property rights are defined properly and can be traded freely.\(^{141}\)

"But having argued that frictionless markets will efficiently resolve externalities, Coase proceeded to show the essential irrelevance of this result owing to the pervasiveness of transaction costs". (Medema, 1999, 212; my italics) This renders the Coase Theorem completely devoid of real-world applicability. When there are transaction costs, it is relevant how responsibilities and rights are granted and transferred.

\(^{141}\) In a recent article Halpin denies that the Coase Theorem, even under the condition of zero transaction costs, is valid. Coase’s argument suffers from three defects, he argues, to wit: the case of no rents (a rent is the amount in which the value of the current activity exceeds the value of the next best alternative); the case of equal rents; and the general error that Coase takes only the factor rent into account and neglects the costs of the buy-out. This has consequences when the person with the greater amount of rent has to buy out all conflicting activity. "(..) the costs of the buy-out may well exceed the value of his own rents, and hence it will be rational for him to abandon his activity in favour of his next best alternative." (Halpin, 2007, 333)
And, therefore, institutions matter. Institutions protect property rights, they supervise the granting and the transfer of property rights, i.e., the content of contracts, the sanctions when contracts are violated etc.

In the end, the message of his article is that the essence of transactions is not the transfer of physical goods or immaterial services, but the transfer of property rights. By granting, specifying or changing property rights the internalization of external effects can be enhanced, and by that allocative efficiency can (indirectly) be increased. This element of Coase’s article about the nature of social costs has become the core of property rights theory.

Coase is critical of mainstream economics. He blames traditional economists for practicing “blackboard economics”, that is, armchair theorizing about a hypothetical world without empirical investigation or case studies. Demsetz called it the “Nirvana approach”, the procedure of comparing the actual economic situation to an ideal, unattainable situation rather than comparing two or more actual or attainable situations. (Demsetz, 1969) Coase criticized the narrowness of mainstream economics in the sense that it excludes from consideration factors in the social world that he thinks should be included in the analysis. Such as the characteristic features of firms and institutions and the costs of using the price-mechanism.\(^{142}\) By incorporating transaction costs into his account, Coase was able to incorporate institutional structures that were previously neglected in serious investigation. Without rules and without the institutional observance of rules, contracts for transactions

\(^{142}\) Coase used the concept of transaction costs relatively late (in 1974). Usually he just spoke about the costs of using the price mechanism. Klaes traces the use of the concept back to Marschak’s (1950) general equilibrium analysis of a monetary economy. Marschak introduced transaction costs as the generalization of investment costs, based on the insight that exchange is a resource-consuming activity. Moreover, he defined the concept as an expression of market imperfections. (Klaes, 2000)
would either not or barely be effected and the internalization of external effects would not be realized.

The normative interpretation of the Coase theorem, however, aroused hostility towards its supporters (the economics of law school). Several normative prescriptions seem to follow from this theorem, such as, that markets solutions are preferable to solutions imposed by the government. Or that, when transaction costs are extremely high rights should be assigned to those who are willing to pay most for them and thus value them most highly. In this case the result will be the same as that which would be obtained by private parties in the market. But the Coase theorem says none of this. "We should look upon it as simply a positive proposition, stating that under certain conditions a particular result will follow". (Medema, 1999, 210)\(^{143}\)

The analysis of social costs raises another question, that is: to what extent should the institutional structure be considered as exogenous. At stake is the following issue. Transaction costs prevent an internalization of external effects when the costs of a reallocation of property rights outweigh the benefits. The implication is that the market cannot be blamed for the existence of all external effects and that not all external effects need to be eliminated. (see Furobotn and Pejovich, 1972, 1142 ff) Neither may it be expected that the government will solve the problem.

We can make a distinction between Pareto relevant and Pareto irrelevant external effects.\(^{144}\) When, after negotiations

\(^{143}\) Coase suggested other possibilities for dealing with externalities in addition to negotiating property rights. The first is the establishment, in the case of producer-producer externalities, of control under a single firm. Another is direct government regulation. And, finally, he suggested that the best solution could be to do nothing at all. The recognition that there are multiple policy options, along with the fact that none of them is optimal, led Coase to advocate a comparative institutional approach to the resolution of externality problems.

\(^{144}\) The distinction between Pareto relevant and Pareto irrelevant external effects originates in an article of Buchanan and Stubblebine. They describe an external effect as potentially relevant when the aggrieved
between rational actors only Pareto irrelevant external effects remain, then the achieved allocation is optimal (efficient). The relevant question in this context is whether the presence of (inevitable) transaction costs is not a pretext to conclude that only Pareto-irrelevant external effects remain. (see Dahlman, 1979) Because of this one should distinguish avoidable and unavoidable transaction costs. For, after all, when it is impossible to ascertain which transaction costs are unavoidable for all actors, then each allocation would be efficient. (Furubotn, 1990)

When discussing the question which transaction costs are inevitable, one immediately encounters the question whether the existing institutional arrangements are efficient. The response to this question is two-sided: either one trusts an autonomous selection process or one wants to intervene. In the first approach one assumes that the existing institutions under the given circumstances, referring to a process of natural selection, are the most effective. In the other case, one will want to find out whether an alternative institution could be designed, in which the transaction costs are reduced, for instance by adapting (property) rights. In both cases the distinction between avoidable and unavoidable transaction costs becomes defunct when there are no alternatives or an alternative is unimaginable.

How far has this brief restatement of Coase’s perceptions brought us? Departing from Coase, it can be established that micro institutional theory focuses on the problem of an efficient allocation, taking transaction costs (and institutions) into consideration. What is at stake is the existence of alternative, allocative arrangements (firms and markets), the existence of alternative institutional arrangements and the question whether institutions are ‘organic’ or ‘pragmatic’ or

party A has the desire to change the behavior of the originator B by exchange, agreement, collective action and the like. An external effect that arouses no reaction is considered as irrelevant. (Buchanan and Stubblebine, 1962, 374) In the discussion above the existence of transaction costs may explain why the aggrieved party decides to forgo any action.
both, to use Menger’s distinction.\textsuperscript{145} Followers of Coase have elaborated his analysis about the existence of firms in two directions: a property rights approach and transaction cost theory. In the latter the discussion is concentrated on firms (hierarchies) and markets as two alternative modes of allocation, in the first the distinction between firms and markets is not seen as very relevant, since one can perceive a continuum of contractual arrangements. The last one judges the efficiency of allocative arrangements in terms of transaction costs, the first one in terms of incentives.\textsuperscript{146}

3. The property right school.

A central element in property rights theory is that property rights provide incentives that influence the agent’s actions. A change in the structure of property rights results in a change in the system of (positive and negative) incentives and, thereby, influences the decisions people make. Property rights theory emphasizes that changing property rights can effect the internalization of external effects. As Demsetz once put it: “A primary function of property rights is that of guiding incentives to achieve a greater internalization of externalities.” (Demsetz, 1967, 248)

Alchian and Demsetz laid the foundations of the theory of property rights in an article in 1972. Like Adam Smith they explain the emergence of firms from the division of labor. Division of labor leads to standardization of production, specialization of activities and by this to an increase in labor productivity. The team generates a quasi-rent, i.e., a result

\textsuperscript{145} Organic institutions are the result of the unintended consequences of human actions, whereas pragmatic institutions are the intended outcomes of human actions.

\textsuperscript{146} The role of contracts is prominent in both transaction cost and property right theory. Williamson regularly describes firms as a “nexus of contract”, but he believes that what is typical for a firm is that authority regulates the coordination. (Williamson, 1991) In spite of the importance of contracts, transaction costs play some, but not a prominent role, in property rights theory.
that is better than the sum of the results that each member of the team would on its own realize on the market. Alchian and Demsetz do not deny that when transaction costs are high it is advantageous to organize the resources within a firm, but considerations related to teamwork and team-organization, considerations on which Coase is silent, are in their view important.

They contest the then dominant opinion that the essence of firms is its hierarchical structure, as a result of which conflicts and differences of opinion are more quickly resolved than when they manifest themselves on the market place. In their opinion there is not really a difference in the power relation between a grocer and his assistants or between the grocer and a customer. As it is the case with the customer and the grocer, the assistant and the grocer continuously (re-) negotiate the contracts, which are acceptable to both of them. Therefore, they conclude that: “long-term contracts between employee and employer are not the essence of the organization we call a firm”. (Alchian and Demsetz, 1972, 777)\textsuperscript{147} What is characteristic for a firm compared with independent working producers is that producers work as a team. The characteristic feature of teamwork is that the contributions of each single member cannot be measured. The only thing that can be measured is the effort of each member. When supervision is lacking and the efforts of the single members of a team are not controlled, there is the risk of shirking and team members may get involved in a free-riders problem. In order to measure their efforts, to determine the payments and to prevent shirking, it is efficient when one member of the team functions as a supervisor and controls the performances of the other members. The members of a team could fulfill this function at turns, but then the advantages of specialization are foregone. Therefore, a permanent supervisor is appointed.

\textsuperscript{147} Alchian and Demsetz later on revised their opinion and acknowledged that long-term contracts can frequently be found. But they don’t put much weight on this point because contracts can be annulled at any time. (see Alchian and Woodward, 1988; Demsetz, 1993)
But then, the question becomes who supervises the supervisor? The solution is to reward the supervisor with the residue that remains when all the other members of the team have received their payments. He has an incentive to discipline the other members of the team and to reduce shirking. In order to fulfill this task the supervisor must have the authority to negotiate the contracts of the individual members and to terminate them when this seems to him unavoidable.

A team is presented as a “coalition of resource owners”. Within the coalition the hierarchy is, in the view of Alchian and Demsetz, based on a relation of exchange. The relation between supervisor and members of the team is a result of the spontaneous behavior of rational actors. We could regard this as a kind of a social contract. Like the selfish individuals in a state of nature who appoint a sovereign, the members of a team choose a supervisor. Alchian and Demsetz want to demonstrate that it is possible to provide a rational explanation for the emergence of organizations. In the analysis of organizations two concepts play a dominant role: ‘adverse selection’ and ‘moral hazard’. (Moe, 1984) Averse selection and moral hazard are useful as theoretical concepts in situations with asymmetric information and in which one party tries to control the behavior of another party by means of material rewards, or in situations in which one tries to realize certain outcomes by structuring the behavior of others. Because the risk of adverse selection is negligible.

148 Agency theory’ or ‘principal-agent theory’ offers a formal approach to a relation in which one party, the principal, considers a contractual agreement with another party, the agent, expecting that the agent will perform actions which deliver results which the principal desires. Principal-agent relations are for instance those between a client and a lawyer, between a patient and a doctor, between citizens and politicians or between employers and employees. The problem of the principal is that he has no guarantee that the agent, once hired, will really serve his interests and serve them efficiently. The agent has his own interests and will only serve the principal when the system of incentives makes it profitable for him to do so. The essential problem for the principal is to develop such a structure of incentives. (see Moe, 1984, 756)
when it concerns team-members, internal reallocation occurs frequently. The manager/supervisor has all the relevant information about the productive talents of the team-members at his disposal. It is more efficient to use the talents and opportunities within the firm than to obtain these from the market. Because of this quality firms can be considered as “a privately owned market”. And that is why “(..), we could consider the firm and the ordinary market as competing types of markets, competition between private proprietary markets and (..) public markets.” (Alchian and Demsetz, 1972, 795).

The model of Alchian and Demsetz is expanded and tailored to specific issues by other authors. Jensen and Meckling (1976) applied it to the supervision of managers. They assume that the costs for supervision are smaller to the degree that the competition on the market for managers is stronger. Also fluctuations in the price indexes on the stock exchanges will discipline managers. In general terms their message is that competition on relevant markets contributes substantially to the discipline of the employees and managers of firms. The idea that markets function as mechanisms for discipline is further elaborated by Fama (1980).

The conclusion that is drawn from this model of the firm is that firms have no ends or objectives other than those of the individual members. A firm is just “a legal fiction’, in which the conflicting objectives of the participating individuals are kept in balance. “(..) the ‘behavior’ of the firm is like the ‘behavior’ of the market; i.e., the outcome of a complex equilibrium process.” (Jensen and Meckling, 1976, 311)

4. Transaction costs theory

The alternative approach, transaction costs theory, is concerned with an examination of the “comparative costs of planning, adapting and monitoring task completion under alternative governance structures.” (Williamson, 1985, 2) Williamson distinguishes three generic kinds of governance structures (or allocative arrangements): markets, hierarchies and hybrid forms (like long-term contracts, franchising,
regulation and the like). With regard to these governance structures he distinguishes three dimensions: the legal aspects of the contracts, the flexibility of the governance structures and the incentive- and control instruments. He predicts that: “... transactions which differ in their attributes, are aligned with governance structures, which differ in their costs and competences, in a discriminating -mainly, transaction cost economizing- way.” (Williamson, 1993, 128)

A central idea of the transaction costs approach is that it is impossible to concentrate the relevant negotiations in the ex ante stage of the making of a contract. Each contract that has to do with the deliverance of a good or service in the future is incomplete. No single contract can specify exactly which actions should be undertaken and which payments have to be done in all possible future circumstances. The reason is that the parties concerned cannot foresee the conditions that have a bearing on the costs of the performances or on the performances themselves. And even when the future conditions are to some extent predictable, it is better to wait and see until the moment is there, instead of arranging everything in advance. The consequence is that contracting parties agree on general performances and procedures for decisions in cases about which the contract is not explicit. Thus, the transaction cost theory emphasizes the implications of incomplete contracts with regard to the negotiations that have to be undertaken in the future.

The behavioral assumptions that Williamson takes as points of departure are bounded rationality and opportunism. Given bounded rationality it is impossible to take all relevant contractual aspects into consideration in advance. This would not be a problem, though, when the contracting parties were not opportunistic. When the parties could trust each other

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149 North and Wallis estimated the size of the transaction costs (or rather the size of the transactions sector in the economy) for the USA at 45% of GNP in 1986. (see North, 1990, 28)

150 Bounded rationality is in this view the combined result of cognitive limitations and of uncertainty concerning future events
completely, all-embracing, but incomplete contracts would be feasible.

The most important dimensions in which contracts differ from each other are: the specificity of assets, uncertainty and frequency. As assets are more specific, the less employable they are for alternative uses. Considering uncertainty, Williamson does not refer to unforeseen future circumstances or to communication problems but to behavioral uncertainty (which springs from opportunism). This is in his view a crucial factor. (see Williamson, 1986, 181) Behavioral uncertainty is irrelevant when one does not depend on certain business partners. In such a situation one can always look for and find new ones. However, when one has entered in specific investments the continuity of commercial relations are crucial and one needs to agree on arrangements to settle disputes. Behavioral uncertainty promotes strategic behavior; in each decision that an agent makes he has to take into account the decisions that other agents are making. The frequency of transactions influences the degree to which one is prepared to submit to specific investments. The more numerous the frequency of transactions and as more specific investments are made, the sooner long term contracts will emerge (which invite more specific investments). To continue the relation mutual guarantees and arrangements to solve conflicts are required. Transactions which frequently recur and in which (at least one of) the commercial partners have (has) submitted to specific investments, take the form of bilateral transactions.

The transition from a situation with many suppliers to a bilateral negotiation position Williamson dubs as the “great transformation”. In bilateral negotiations the struggle about the distribution of the quasi-rent can generate negotiations inefficiencies. For these transactions specific governance structures will be designed. The transactions will be lifted from the market and be organized within firms (vertical integration). The advantages of firms compared to markets to harmonize bilateral transactions are that the incentives to suboptimal functioning are reduced and that conflicts of
opinion can more easily and cheaply be solved, because each has access to all information. (Williamson, 1981, 559)

It is Williamson’s firm belief that firms do not aim at market dominance. Characteristically they want to realize a more efficient organization. We can trace this view back in one of the most controversial elements of his analysis, namely his approach to vertical integration, or, more specifically, in his attitude towards anti-trust legislation.

The most important reason for vertical integration is that firms have made specific investments. Vertical integration is efficient with an eye to economizing on transaction costs, though it may increase market-concentration. Williamson believes that, in spite of opinions to the contrary, concentration is not a sufficient condition for reducing competition. As long as firms have free entry to the market, a monopolistic market structure does not necessarily have to invoke monopolistic behavior, for big profits will attract other firms. Thus, market concentration is not a consequence of a policy to gain market-power, but is the result of an ambition towards greater efficiency. Transaction cost theory contributes in this way to a greater unification of economic theory, for: “What has hitherto been regarded as a set of diverse and anomalous practices has been shown to be variations on a common theme: economizing on transaction costs.” (Williamson, 1986, 199)

Perrow, however, believes that Williamson’s view is

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151 Firms are, in the terminology of Williamson, ‘economizers’, not ‘strategizers’. Power does not play any role in Williamson’s approach. In his view the concept of power is vague and diverse.

152 In this Williams shows affinity with the theory of ‘contestable markets’ of Baumol. (Baumol, 1982) Baumol takes as a measure of a competitive market the degree in which free entry is possible. However, Williamson explicitly dismisses this theory because it does not take into account the firm-specific qualities of the employed inputs. (Williamson, 1985, 31n) Baumol’s theory, by the way, also fits closely with the property rights theory.

153 It should be realized that vertical integration is an integral part of the decision to make or buy. The criticism is directed against vertical integration with the objective of acquiring market domination.
completely unfounded. Firms are taken over to gain control of the market and to expand the sources of profit. (see Perrow, 1986)\(^{154}\)

Another criticism is that transaction cost theorists tends to see authority primarily as a remedy for opportunism, rather as a device that might be abused in an opportunistic fashion. Dow complains that Williamson treats the phenomenon of opportunistic action quite asymmetrically when comparing employees and managers. “Systematic analysis of the ways in which authority relations may elicit novel forms of opportunism, qualitatively different from those found in direct bargaining is virtually absent.” (Dow, 1987, 20; see also Marginson, 1993)\(^{155}\)

A further point of criticism that is mentioned is that transaction cost theory emphasizes exchange to the exclusion of production. In addition it underplays the role of technology as a factor in explaining organizational forms. This criticism probably is right, but the emphasis on exchange is perfectly justified in a theoretical framework in which the focus is on the transfer of property rights, a transfer in which transaction costs play such a crucial role. \(^{156}\)

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\(^{154}\) In a review article of research projects testing transactions costs theory, Lafontaine and Slade report, "the weight of the evidence is overwhelming. Indeed virtually all predictions from transaction costs analysis appear to be borne out by the data." (Lafontaine and Slade, 2007, 658) They also conclude "under most circumstances, profit-maximizing vertical-integration decisions are efficient, not just from the firms' but also from the consumers' point of view." (Ib., 680)

\(^{155}\) These are prophetic words, as we witnessed the scandals around Enron and other companies in 2001-2003, in which managers cheated their shareholders and employees and enriched themselves shamelessly to amounts of hundreds of millions of dollar. In 2008 we witness the financial crisis due to the greed of those responsible for the financial bubble.

\(^{156}\) Langlois and Foss argue for a capability perspective, which conceptualizes the firm as a repository of productive knowledge. A key aspect of the critique of transaction costs theory is that it too strictly dichotomizes production and transaction costs and neglects the role that both play in determining the boundaries of the firm. Langlois and Foss emphasize the complementarity between the two perspectives and the need for integrative efforts. (Langlois and Foss, 1999)
5. Firms and markets

What are the most outstanding differences between the two approaches? Property right theory emphasizes the costs and the supervision of existing contracts, assuming ex ante designed efficient institutions. In transaction cost theory the emphasis is laid on safeguarding agreed upon contracts, against the background of opportunistic behavior of commercial partners in combination with unexpected external events. Therefore it is more concerned with the negotiation- and decision costs related to ongoing contractual negotiations. (see Alchian and Woodward, 1988; Foss, 1994)

The property rights school employs the discrete contract-paradigm. i.e., it is directed towards market transactions which are frequent and in which the commercial partners do not make specific investments. The content of the contracts are laid down in established contractual standards and legal rules. Market alternatives are the main protection against opportunism.

The main lesson the transaction cost theory teaches, when moving from simple to complex contracts, is that all complex contracts are unavoidably incomplete. The move from simple to complex contracts is therefore attended by a whole series of features: the length of the contracts increases, penalties to deter breach are introduced, provision is made for added information disclosure and specialized dispute settlement mechanisms appear. (Williamson, 2000) Williamson defines the differences between hierarchies and markets as follows: “(...) under hierarchy, incentive intensity is less, administrative controls are made numerous and discretionery, and internal dispute resolution supplants court ordering. “ (Williamson, 2002, 180) But these differences seem rather to indicate a continuum of contractual relations, than a clear-cut distinction between firms and markets.

Coase referred to the employment relation as the defining feature of the firm. After all, one integrates productive activities within a firm to exercise control. Alchian and Demsetz assert that authority (the ‘visible hand’) is not a
relevant concept for the analysis of the firm. The main reason that they refuse to make a difference between the invisible hand in the market and the visible hand in the firm is that they assume that the members of a team are interchangeable with factor owners on the market. The exit-possibilities are numerous and the exit-costs negligible. This is why external markets function as disciplining mechanisms. Accordingly a firm is presented as a ‘nexus of contracts’. When the circumstances require this, the contracts can take all forms and from this point of view the differences between the contracts of partners in markets and those within firms are only minor. In fact it is a matter of a continuum of alternative contractual arrangements. (Cheung, 1983)

To argue for the case that the firm is distinct from the market, it should be demonstrated that a firm functions ‘as if’ it is a ‘corporate actor’, an acting, deciding unit. Khalil argues that in order for the firm to be recognized as an individual, the firm should be considered to be a goal-directed agent. Essentially is that the goals of the firm are not based on mutual interests but are the product of organizational routines (which represent also the competences of the firm). The individual interests within an organization only become manageable when the members submit themselves to an agreed upon goal, and this submission implies that they have agreed to give up some rights to the authority of the

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157 Vanberg proposes that we look upon the firm as a constitution. (Vanberg, 1992) The advantage of this paradigm, in his opinion, is that it clearly distinguishes itself from the contract paradigm for there is no analogy between the rules within a firm and the rules of the market. (see also Ouchi, 1980; Simon, 1991)

158 Winter directs our attention to the fact that it is the firm, not the people who work within a firm, that is the bearer of the repository of productive knowledge. Firms and organizations know how to do things. Productive knowledge is preserved in firms while individuals come and go. (Winter, 1991) Winter’s argument strengthens the idea of the capability perspective that much firm-specific knowledge is tacit and can be learned by doing and is not possessed by one single agent.
organization. (Khalil, 1997) Viewed in this way, the assertion that a firm is an acting unit boils down to the statement that the firm is a hierarchy.

In spite of the arguments of Alchian and Demsetz that authority is merely a surface phenomenon, the fact is that employers and employees are not legal equals. Coase understood the nature of the employment contract as one in which the employer will pay an agreed remuneration in exchange for the privilege of asserting authority over the employee. In “The nature of the firm” Coase says that: “We thus see that it is the fact of direction which is the essence of the legal concept of ‘employer’ and ‘employee’, just as it was in the economic concept, (.....). We can therefore conclude that the definition we have given is one which closely approximates the firm as it is considered in the real world.” (Coase, 1988, 54) The economic concept corresponds to a legal conception of the firm that is supposed to be as adequate about the firm as it is in the real world.

A further significant difference between market relations and relations within the firm is that the market relations are reversible. In markets a buyer can always become a seller. The reversibility of positions under traders does not exist within an authority structure (Ménard, 1995)

Whether or not these arguments are convincing (I think they are), and, thus, whether or not the firm is a hierarchy, there is one thing that is not under dispute and that is that there is a clear difference of opinion between adherents of property rights theory and the transaction cost theory concerning this issue.

6. Selection and design

In quite a lot of economic analyses it is assumed that existing allocative arrangement have proven their efficiency in competition with alternative arrangements. (for a comment, see Hodgson, 1993; Vromen, 1994) To substantiate this thesis reference is often made to a well-known article of Alchian from 1950 to which I referred in chapter II. In this article,
Alchian asserted that firms that are well adapted to the demands of the environment would be selected by the economic system to survive, while other firms will disappear. Successful, profit-making firms can dispose over more resources and will expand, while firms that do not succeed in adapting themselves to the demands of a changing environment shrink and ultimately disappear. Alchian wrote this article in response to the so-called “marginalism debate” which was concerned with the realism of the assumptions of marginal analysis. Alchian argued that the assumption that firms are profit-maximizers is without basis when uncertainty prevails. He formulated an alternative approach in which the motives of the agents and their knowledge of the outcomes of alternative options are irrelevant. This model only assumes the presence of a varied population of firms. The environment selects the firms that are successful, that is, which make a profit.\(^{159}\) Neo-classical theory should not be understood, he emphasized, as a theory of individual behavior, but as a theory of (aggregated) market behavior. Irrespective of the considerations of single agents, natural selection will see that the tendencies predicted by neo-classical theory prevail. Alchian extended the model of natural selection with adaptive behavior (especially, imitation). In this model, imitation, innovation and positive profits are the economic counterparts of genetic inheritance, mutation and natural selection of the biological model.

Natural selection explains states of affairs without entering into goal-oriented behavior on the micro level. Evolutionary developments emerge through the transfer of genetic changes that occur by sheer accidence. When applied to economic science one has to introduce irrational behavior (accidental behavior without objectives).\(^{160}\) When employers are unable

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\(^{159}\) Alchian makes it quite clear that his approach dispenses with profit-maximization. The reason for this is uncertainty. The thesis that natural selection “produces” profit-maximizing firms is one to which he did not subscribe. (see also Kay, 1995)

\(^{160}\) Becker (1962) has tried to show that actions of irrational agents, when
to do more than act on the basis of unreflective intuitions, then, of course, one can only explain the outcome by means of natural selection. But when they can do better than this, there is no reason to use the mechanism of natural selection (which would be of no use in such a situation anyway). (Lagueux, 1993) Given the various complications which arise when metaphors derived from biology are applied in the economic science, it seems more sensible to refrain from references to natural selection and to introduce an autonomous evolutionary mechanism, for instance adaptive learning (Vromen, 1994) or cultural evolution.\footnote{Lagueux, 1993}

The efficiency of allocative arrangements is also determined by the efficiency of supporting institutions. That a certain kind of selection accompanies the evolution of allocative arrangements is, given competition in markets not hard to believe. But what about institutions? Can we apply some kind of selection argument to the evolution of institutions? Hayek, who emphasized cultural evolution, took the view that institutions arise spontaneously as the unintended consequence of individual actions. A process of variation and selection insures that only those behavioral rules survive which are beneficial for the group in which they came into being. However, he does not indicate how, through which mechanism, those rules survive and are replicated.\footnote{Hayek, 1960} There is no ‘market’ for institutions and the chance that a spontaneous competitive process becomes operative can be excluded.

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\footnote{Hayek attached great value to the idea of a spontaneous order. In his view a spontaneous order is a precondition for a free order. A designed order, in contrast, is a planned order. (Hayek, 1960) (see also chapter XXV)}
Indeed there are all kinds of economic and political interests and professional opinions. Thus there is more than one ‘mechanism’ that is accountable for the selection of the ‘fittest’ rules of behavior. There is no reason to assume that the economically most efficient one will be selected. Research by North (1990) indicates, moreover, that inefficient institutions can survive for a long time. Institutional change takes, in most cases, the appearance of marginal adaptations of a complex of rules, norms and laws that together constitute the institutional framework. Institutions are reproduced and transformed in the ongoing daily practices.

As a matter of fact, neither the efficiency of existing allocative arrangements nor the efficiency of existing institutions can be demonstrated by means of the natural selection argument. The natural selection argument is based on random variation and selection. There is no reason to believe that it has any relevance to allocative and institutional evolution. Nevertheless both property rights theory and transaction cost theory (in Williamsons’ version) endorse the idea of natural selection with regard to contractual arrangements and ‘governance structures’, respectively.

The market process is often cited as the paradigm case of an evolutionary process. The evolutionary nature of the market process is grounded on the openness of the market for new variations and competitive selection among variants. This is compatible with the emphasis in property rights theory on the entry and exit opportunities for firms and associations on the market. In transaction costs theory the idea of the evolution of allocative arrangements is more associated with the capacity to create and disseminate novelty, which creates the coexistence of a variety of allocative arrangements. Variety is a crucial factor in explaining the dissemination process that make up the lion’s share of observed evolutionary processes. But novelty in the context of allocative arrangements emerges from more or less actively pursued attempts to design improved arrangements.

Therefore, I believe that natural selection is more compatible with property right theory than with transaction cost theory.
Given this assumption I will argue that the combination of the property rights approach with the idea of the natural selection of allocative and institutional arrangements and the combination of the transaction cost theory with the idea of design of these arrangements results in two clearly distinctive schools of thought. They can respectively be named the neo-(classical) institutional theory and the new institutional theory. I compare this distinction with the one Eggertsson has proposed.

Eggertsson views the neo-institutional theory as an extension of neo-classical theory through the insertion of new constraints (transaction costs and property rights). (Eggertsson, 1990, 6) The ‘hard core’ of neo-classical theory remains as it is, but with the insertion of new constraints the ‘protective belt’ is changed. New institutional theory, which he associates with Williamson, rejects, in the view of Eggertsson, elements of the ‘hard core’ of neo-classical theory, for instance, the assumption of unbounded rationality. (Ib., 9) What would an outline of the new institutional theory look like? We meet some problems here. Eggertsson does not provide one, except his remark about bounded rationality, and it looks like there is only an initial impetus to a new institutional theory. (see also Langlois, 1986; and chapter X, section 7)

7. The neo-institutional theory

Neo-classical institutional theory, as characterized by Eggertsson, satisfies my description of property rights theory.

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163 Foss (1994) also distinguishes these two theories. His view, however, is based on ontological arguments derived from transcendental realism.

164 In chapter One I expressed my doubts that the introduction of bounded rationality really matters that much (an exception is the case in which the skills to process information are overcharged). By introducing information costs it is easy to argue that it can be rational (efficient) to use rules of thumb etc. I believe that the combined assumptions of opportunism and design are what distinguish Williamson’s approach from the orthodox neo-classical theory.
Referring to the distinction between markets and firms Eggertsson notices that it is not easy to define a firm and that: “In fact, the dichotomy of the firm versus the market is unlikely to be a helpful instrument in our search for [a] better understanding of exchange.” (Eggertsson, 1990, 48/9) Instead of trying to define ‘what is a firm’, it is more productive to study a number of contractual forms and arrangements. Neo (-classical) institutional theory is particularly interested in the question why one contractual form dominates another: “Central to neo-institutional theory is the concept of competition among contractual arrangements”. (Eggertsson, 1990, 53) Competition assures that the most efficient arrangements survive. Competition leads, in this view, to a process of natural selection. In the end this results in a situation of allocative equilibrium. The dominance of specific arrangements is considered to be a sign of an evolutionary stable equilibrium.

In neo-institutional theory the state fulfills an important function in maintaining property rights. The uncertainty about the (political) results of institutional change is a strong motive for institutional stability.

Characteristic for neo-institutional theory are:

1. exchange is generalized and in this way utility maximization is extended to choices whether made by parents, by managers, or by civil servants. (see Furubotn and Pejovich,1972; De Alessi,1983)

2. property rights and transaction costs are admitted among the constraints that agents face and are considered as data.

3. natural selection assures that efficient arrangements survive.

These characterizations do fit quite well with the market orientation of rational choice theory as incentive-led behavior. The behavior of organizations is explained by observing the behavior of the individuals within the organization. The organization itself is not a unit of analysis. In the utility function not only monetary rewards are admitted but also non-monetary ones.
The admittance of property rights and transaction costs has important consequences for the treatment of externalities when the constraints are conceived as data. The point of departure in the case of externalities is that the parties involved should try to solve the problem themselves by means of negotiations. When the costs of internalizing external effects outweigh the benefits, then the remaining external effects are Pareto-irrelevant. The equilibrium is, by definition, efficient. “If the constraints describe our world, then we must conclude that the world is optimal relative to our constraints.” (Dahlman, 1979, 154) The view of De Alessi (1983), for instance, is that the efficiency of the economic system must be defined as efficiency given transaction costs and the system of property rights (and all the -general and unavoidable- rules that follow). But this leaves the efficiency of the prevailing system of property rights, which is mainly dependent on the political system, out of account.

8. The new institutional theory

Both in neo-institutional theory as in new institutional theory the central question is the “make or buy” question. The attitude towards this question determines the distribution of economic activity between firms and market. Williamson supplements the model of the firm as a production function with the concept of the firm as a governance structure. In this way the focus moves from the technologically determined input-output relation to the question of organizational efficiency. Opportunism extends the classic notion of self-interest to encompass ‘self-interest with guile’. And this makes allowance for strategic behavior.

In transaction costs economics, the transaction is made “the basic unit of analysis”. (Williamson, 1985, 18) Not the choice-actions of isolated agents but the contractual relations between agents form the micro-foundation of new institutional theory.\(^{165}\) New institutional theory focuses on

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\(^{165}\) Williamson refers to Buchanan who once said: “(..), economics comes
the comparative analysis of institutional arrangements. In doing this, contractual and institutional arrangements between economic units are analyzed which can influence the way these units either cooperate or compete. (Williamson, 1993) With regard to the efficiency of an arrangement he makes a similar reservation as is done with external effects in the neo-institutional school. A certain situation is only inefficient when there exists a feasible (and better) alternative.\footnote{166}

Instead of the concept of equilibrium the concept of economic evolution is used to account for the development of markets and firms in relation with institutional development. Concerning the evolution of governance structures Williamson says that “(...), the transaction cost approach relies (...) on the operation of natural selection forces.” (Williamson, 1981, 574) Natural selection makes governance structures which economize on transaction costs replace the more expensive governance structures in due time. Williamson presents as an example how the multi-divisional structure (the M-form) emerged. Firms with a functional structure (the U-form) experienced problems with regard to supervision and strategy determination. The U-form did not function very well and was replaced by the M-form. But Williamson errs here; this is not how natural selection operates. A natural selection argument would be that the arrival of the M-form would lead to the decline of the inferior U-form. The replacement of the U-form by the superior M-form is more a matter of the imitation of a successful new organizational design. Williamson’s analysis is more Lamarckian than Darwian. (Kay, 1992)

\footnote{166}{The efficiency standard out of which transaction cost economics works further eschews Pareto-optimality in favor of a remediableness standard - according to which an extant condition is held to be efficient unless a feasible alternative can be described and implemented with net gains.” (Williamson, 1994, 33)}
The idea of natural selection neither goes together with a theory in which the specificity of assets plays such a dominant role. Rather, it seems consistent with the approach of transaction cost theory to consider the market as a complex of networks. In these networks firms (suppliers and customers) develop enduring relations. They are able to decrease the costs of production and transaction due to these enduring relations in which they acquire knowledge about each other. Of course, they become more interdependent and this reciprocal dependency can be asymmetrical. But this interdependency strengthens the durability of the relation. A common language is developed with regard to technical details, contract rules and the standardizing of products and processes. The market is not characterized by "hit-and-run-competition" (Baumol), but by enduring relations within networks. Thus there is no reason to ground the new institutional approach on blind selection. More fundamental is the idea of adaptation and design. The design of governance structures must, of course, be supplemented by the design of new routines that are internal to the organization. Whether also ‘external’ institutions have to change is a question that cannot be answered with a simple yes or no. There is no one-to-one correspondence between the behavior of organizations, the functioning of markets and the institutional environment.

Williamson has lately distinguished four levels of social analysis. He may have taken this step in reaction to the criticism of Granovetter (see section 9). The top level is the social embeddedness level. This is where the norms, customs, traditions, etc, are located. This level is taken as given by

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167 Nelson and Winter present firms as repositories of productive knowledge, in which technology and organization are inseparable constituents of the ability to do things. We could infer from this that the firm is an amalgam of routines evolving through time. Thus, we could envisage an evolutionary theory in which evolving routines make it possible for firms to adapt to a changing environment. Though the authors accept natural selection, they simultaneously view their theory as Lamarckian rather than Darwian. (Nelson and Winter, 1982, 11)
most institutional economists. It is assumed that many of the informal institutions at this level have mainly a spontaneous origin. The second level is defined as the institutional environment. The structures observed here are in part the product of evolutionary processes, but design opportunities are also posed. Going beyond the informal constraints of level one, here formal rules are introduced (such as laws and property rights). The third level is the level where the ‘institutions’ (sic!) of governance are located. The governance of contractual relations becomes the focus of analysis. Governance is an effort to craft order, thereby to mitigate conflict and realize mutual gains.\(^{168}\) The fourth level is the level at which neoclassical analysis works. Optimality conditions, usually marginal analysis, are employed, and the firm is for these purposes typically described as a production function. (Williamson, 2000) He claims that when one moves through the levels, the time scale of persistence decreases and the role of calculative behavior increases. New institutional theory is predominantly concerned with the levels two and three. And it is within these levels that the idea of design of institutions is admitted. Therefore, and to conclude this section, we can maintain that the design of firms as well as of institutions is characteristic of new institutional theory.

9. Conclusion

In the preceding sections I have explained that the seminal ideas of Coase, together with those of his followers, provide

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\(^{168}\) The confusion about organizations and institutions can be illustrated with the definition of the third level. Williamson often talks about alternative governance structures as institutional arrangements when he refers to markets and firms. Here he talks about institutions of governance. He might mean to refer here to the rules, regulations or routines that are accepted to govern the contractual relations in which the firms are engaged. But he also distinguishes the institutional environment (level two) as the ‘rules of the game’ from the institutions of governance (level three) as the ‘play of the game’ (thus as markets and firms).
the foundation for two kinds of institutional theories. The basis for this dichotomy was the distinction between markets and firms (or the denial of the relevance of this distinction) on the one hand and the distinction between natural selection and design on the other. With regard to the distinction between firms and markets the difference between the two theories seems, on the surface, to be small. Both neo-institutional as new institutional theory regard a firm as a complex of contracts. But there are relevant differences. Williamson emphasizes the juridical differences between contracts on the market and contracts within a firm.  

Characterizing a firm as a 'corporate actor', or hierarchy strengthens the distinction between markets and firms. Property rights theory is focused on the efficient level of supervision and the like, given input, output and technology, while transaction costs theory is looking for the most efficient mix of governance structures.

A controversial aspect of transaction costs theory is that vertical integration or mergers are only judged by efficiency standards. That a resulting corporation may have a turnover that is more than the GNP of a middle size welfare state is no reason to treat it in any way different from a local, small-

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169 Moreover, we could distinguish transactions (at the market) from transfers (within firms). (Kay, 1992) And a distinction could also be made between transaction costs and the costs of managing. The first are the costs for organizing resources through the market, the second are the costs for organizing resources within firms. When deciding to make or to buy (to integrate or not), one should look at the lowest average costs. All costs should be taken into account, i.e., transaction costs, managing costs and production costs. (Demsetz, 1993)

170 To see the firm as a corporate actor is for many a troublesome notion because it conflicts with methodological individualism. But the dogma of methodological individualism is based on the concept of the individual, as a ‘homo clausus’ that also is a troublesome notion.

171 Product- and process innovation, the creation of markets, the creation of expertise within firms, all issues which bear immediately on the functioning of firms are, however, hardly mentioned. The ‘contractual’, ‘constitutional’ firm is not a strategic unit but a reactive, economizing one. (Foss, 1993)
sized company or even a local shop. But size matters and to overlook this is not a minor incident.

In spite of the correspondences, the central perspectives of the neo- and the new institutional theory do differ strongly. The neo-institutional theory is a combination of property rights theory and evolutionary (game) theory and is strictly market-oriented. It does not acknowledge an analytical distinction between a market and a household. The new institutional theory is a combination of transaction costs theory and ideas about bargaining and cultural evolution. It sees firms as social embedded and thereby it does make a strict distinction between markets and society.\textsuperscript{172}

What has been the contribution of these micro-institutional theories to the understanding of the way the metaphor of the invisible hand should be interpreted? In order to be able to answer this question, another question has to be answered first. This is the question whether these theories can be characterized as institutional theories at all?

In the ‘old’ institutional theory (connected with the ideas of Veblen, Commons, and Ayres), institutions occupy the regulatory role of markets in neoclassical theory. The difference between an institutional approach and a market approach was, therefore, easy to see. Things are different in the comparison between these micro-institutional theories and neoclassical theories. Whereas the ‘old’ institutionalists aspired to replace neoclassical theory, micro-institutional theories show a marked affinity with the body of ideas of neoclassical theory, as all make the question of allocative efficiency central and embrace methodological individualism. This is particularly evident in the case of neo-institutional theory.

\textsuperscript{172} Looking back at the two approaches of rational choice theory that I mentioned in the Preface it should be clear that the neo-institutional and the new institutional theory lay the foundations of respectively a market oriented incentive led approach and a comparative, transaction costs based approach.
One wonders whether these micro-institutional theories should indeed be characterized as institutional theories; all the more because the concept of an institution is not always used precisely. (see Khalil, 1995; Ménard, 1995). Usually institutions are defined as rules of behavior or as behavioral regularities. In the economic sphere their use is restricted to refer to those formal and informal rules that are related to transactions and contracts. Many of these rules refer to (the transfer and protection of) property rights and to sanctions in those cases in which contracts are not fulfilled. But in these micro-economic institutional theories markets and organizations are sometimes also called institutions.\textsuperscript{173} This is very confusing. Organizations are acting units (as are households) and we should keep the players and rules apart (see also North, 1994). Organizations, as households or firms can be treated ‘as if’ they pursue a particular set of goals. Rules of behavior function either as constraints on actions or are enabling for pursuing specific actions. A market can be described as an ‘organic’ structure for the coordination of economic actions by means of the price mechanism. The market is a context for action, not a rule for actions. Of course, there are connections between institutions, markets and organizations, because the latter two function within an institutionalized environment. One source of the confusion is that institutions are made operational through organizations (institutes) whose role is to monitor, enforce and manage the set of rules of those institutions.\textsuperscript{174}

\textsuperscript{173} Williamson called governance structures institutions (see note 168) and Coase defined markets as “institutions that exist to facilitate exchange, (..)” (Coase, 1988, 7) Institutions are not simple organizational structures. They are normative patterns that define what are felt to be the proper, legitimate or expected modes of behavior.

\textsuperscript{174} Following North many authors distinguish the institutional environment, which comprises the institutions defined as behavioral rules and patterns, from institutional arrangements, as markets and firms are called. I think this usage rather than solving the confusion, strengthens it.
Let us now return to the initial question: how have the micro-institutional theories made the invisible hand ‘visible’? Both theories have explained the coordination of economic activities by referring to both formal and informal rules, which protect, support and facilitate market exchange (institutions that define property rights, protect contracts etc.). What is more, new institutional theory has replaced anonymous markets by markets structured by firms. In this way the invisible hand is partly replaced by a visible hand at the micro level. In addition new institutional theory emphasizes the role of institutions in reducing transactions costs and in coordinating activities.

Williamson has come to acknowledge the “embeddeness thesis”, the view that governance structures are embedded in a whole configuration of social institutions. But he takes these (first level) institutions as given and in his view they have no explanatory function in new institutional theory. Granovetter formulated the embeddeness thesis by way of complement to Williamson’s analysis. He stressed the role

175 Coase did adopt a notion of the whole complex of social institutions. In his view the costs of exchange depended on the legal system, the political system, the social system, the educational and cultural systems, and so on. “In effect it is the institutions that govern the performance of an economy, and it is this that gives the “new institutional economics” its importance for economists.” (Coase, 1998, 73) We witnessed the importance of the basic institutional structure when the “shock therapy” in the former Soviet Union failed.

176 Granovetter’s article is frequently cited but it is rarely acknowledged that it was written as a comment on Williamson’s “The Economic Institutions of Capitalism”. Granovetter argued that there is evidence that business relations are mixed up with social ones. Among top managers it is very unusual to speak about legal rights or to threaten to sue. Trust is an asset and the settlement of disputes is eased by the embeddeness of business relations in social ones.

Williamson’s appeal to hierarchical relations (within firms) to tame opportunism and shirking is a consequence of a perception of the market with asymmetrical information as imperfectly competitive markets, characterized by sunk costs and specific human capital. These imperfect competitive markets almost seem to reflect Hobbes’s state of nature and a hierarchy seems the obvious solution. But Granovetter asserts that there
of concrete personal relations and structures (or networks) of these relations in generating trust and discouraging malfeasance.

Hierarchies and institutions that structure markets and coordinate the actions of individual agents replace the invisible hand. Of course, this does not deny that markets, firms and institutions initially developed unintentionally, but when they matured they were consciously adapted and transformed. In the long run they stabilized and routine behavior established and reproduced a set of rules, and norms, ‘fixed’ by habits and conventions, tacit or legally supported through social acceptance and conformity. They help agents to develop (normative) expectations concerning the actions of other agents.

This second version of the invisible hand better explains how a market society without a central authority can function in a benevolent way than the first version. Rule-based behavior helps to solve coordination problems by creating reciprocal normative expectations. The unintended consequences of intentional actions result in the reproduction and development of institutions.

Though new institutional theory offers more than general equilibrium theory, it still offers not enough. In the first place its view of institutions is not quite adequate. Therefore, I will proceed by describing some characteristics of an institutional theory in the next chapter. Second, it has not solved the problem of how institutions can be both products of and conditions for human action. I discuss this problem in the chapters XI and XII and then supplement the characterization of institutional theory with a theory about the relation between agency and structure in chapter XIII.