

Lecture XI: Williamson – Chapters 2 & 3

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I. Readings for next time

- Williamson, O.E. 1985. *The Economic Institutions of Capitalism*, Free Press – Chapters 4 and 6.

II. Introduction

- A. In this chapter we see Williamson's primary construction for economic organization – Economic organization is determined by
 1. Asset Specificity,
 2. Uncertainty, and
 3. Frequency.
- B. However, the primary factor driving the transaction into nonstandard governance is asset specificity.

III. Contractual Man

- A. Asset Specificity.
 1. A critical piece of this discussion is the meaning of an relationship specific asset.
 2. It must be more than fixed
 - a. Many fixed assets are "redeployable" they can be used in other uses.
 - b. Trucks can be used outside agriculture.
 - c. Combines can be used for several crops and ultimately by other farmers.

- d. What about breeding stock?
- 3. "Suffice it to observe here
 - (1) asset specificity refers to durable investments that are undertaken in support of a particular transaction, the opportunity cost of which investments is much lower in best alternative uses or by alternative users should the original transaction be prematurely terminated, and
 - (2) the specific identity of the parties to a transaction plainly matters in these circumstances, which is to say that continuity of the relationship is valued, whence
 - (3) contractual organization safeguards arise in support of transactions of this kind, which are unneeded (would be the source of avoidable costs) for transactions of the more familiar neoclassical (nonspecific) variety."

B. Rationality

- 1. Maximizing – Strong Rationality
- 2. Bounded Rationality.
- 3. Organic Rationality – Evolutionary institutions.

C. Self-Interest Orientation

- 1. Williamson develops three levels of Self-Interest Orientation
 - a. Opportunism – self-interest seeking with guile.
 - b. Simple Self-Interest Seeking – this merely presumes that bargains are struck on terms that reflect original positions.
 - c. Obedience – obedience is the behavioral assumption that is associated with social engineering.

D. Uncertainty

E. Frequency

- 1. As the frequency of transaction increases, asset specificity becomes less problematic.
- 2. Transactions that occur frequently have less uncertainty – more information is available or at least obtainable.

IV. Governance of Contractual Relations

A. Contracting Traditions

	Behavioral Assumptions	
	Rationality	Self-Interest Orientation
Strong	Contingent Claims Mechanistic Design	Transaction Costs Mechanistic Design
Semi-Strong	Transaction Costs Team Theory	Contingent Claims
Weak	Evolutionary	Utopian Team Theory

Figure 1: Behavioral Assumptions

1. Classical Contract Law – Classical contract law endeavors to implement discreteness and presentationa in several ways.
 - a. The individual is irrelevant – the economic man.
 - b. The agreement is carefully delimited (written features)
 - c. Remedies are narrowly perscribed.
 2. Neoclassical Contract Law
 - a. First, not all future contingencies for which adaptations are required can be anticipated at the outset.
 - b. Second, the appropriate adaptations will not be evident for many contingencies until the circumstances materialize.
 - c. Third, except as changes in states of the world are unambiguous, hard contracting between autonomous parties may well give rise to veridical disputes when state-contingent claims are made.
 3. Relational Contracting – Progressively increasing the "duration and complexity" of contract has thus resulted in the displacement of even neoclassical adjustment processes by adjustment processes of a more thoroughly transaction-specific, ongoing administrative kind.
- B. Efficient Governance
- (1) Suppliers and buyers intend to be in business on a continuing basis: thus the special hazards posed by fly-by-night firms can be disregarded.
 - (2) Potential suppliers for any given requirement are numerous – which is to say that *ex ante* monopoly in ownership of specialized resources are assumed away.
 - (3) The frequency dimension refers strictly to buyer activity in the market.
 - (4) The investment dimension refers to the characteristics of investments made by suppliers.
- C. Several propositions are suggested immediately:
- (1) Highly standardized transactions are not apt to require specialized governance structure.
 - (2) Only recurrent transactions will support a highly specialized governance structure.

		Investment Characteristics		
		Nonspecific	Mixed	Idiosyncratic
Frequency	Occasional	Purchasing Standard Equipment	Purchasing Customized Equipment	Construct a Plant
	Recurrent	Purchasing Standard Material	Purchasing Customized Material	Site-Specific Transfer Of Intermediate Product Across Successive Stages

Figure 2: Efficient Governance

- (3) Although occasional transactions of a nonstandardized kind will not support a transaction-specific governance structure, they require special attention nonetheless.

D. Types of Governance

1. Market Governance
2. Trilateral Governance
3. Bilateral Governance
4. Unified Governance

		Investment Characteristics		
		Nonspecific	Mixed	Idiosyncratic
Frequency	Occasional	Market Governance (classical contracting)	Trilateral Governance (neoclassical contracting)	
	Recurrent		Bilateral Governance (relational contracting)	Unified Governance

Figure 3: Efficient Governance