

# Lecture XI: Williamson – Chapters 2 & 3

Charles B. Moss

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Readings for next time

Introduction

Contractual Man

Governance of Contractual Relations

## Readings for next time

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

# Introduction

- ▶ 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.
- ▶ However, the primary factor driving the transaction into nonstandard governance is asset specificity.

# Contractual Man

## ▶ Asset Specificity.

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

► "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."

# Rationality

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

# Self-Interest Orientation

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

# Behavioral Assumptions

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

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

# Contracting Traditions

- ▶ Classical Contract Law – Classical contract law endeavors to implement discreteness and presentationa in several ways.
  - ▶ The individual is irrelevant – the economic man.
  - ▶ The agreement is carefully delimited (written features)
  - ▶ Remedies are narrowly perscribed.

- ▶ Neoclassical Contract Law
  - ▶ First, not all future contingencies for which adaptations are required can be anticipated at the outset.
  - ▶ Second, the appropriate adaptations will not be evident for many contingencies until the circumstances materialize.
  - ▶ 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.
- ▶ 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.

## 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.

# Efficient Governance

|           |            | 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 |

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

# Types of Governance

- ▶ Market Governance
- ▶ Trilateral Governance
- ▶ Bilateral Governance
- ▶ Unified Governance

# Efficient Governance

|           |            | Investment Characteristics                   |                                                     |                    |
|-----------|------------|----------------------------------------------|-----------------------------------------------------|--------------------|
|           |            | Nonspecific                                  | Mixed                                               | Idiosyncratic      |
| Frequency | Occasional | Market Governance<br>(classical contracting) | Trilateral Governance<br>(neoclassical contracting) |                    |
|           | Recurrent  |                                              | Bilateral Governance<br>(relational contracting)    | Unified Governance |