The Economics of Governance:

An Overview

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Mr. Rector, Mrs. Recktenwald, Colleagues, Ladies and Gentlemen:

The one page version of Horst Claus Recktenwald's impressive curriculum vita concludes as follows: "Throughout his life Recktenwald attempted to use his research to combine the tradition and historical evolution of economics with the practical approach of science, using results of formal theory and empirical work to gain insight into economic and social reality." My research does not track that description exactly, yet there are commonalities.

Thus I, like Professor Recktenwald, have attempted to combine theory with applications, to take a broad view of economics (by drawing selectively on law, especially contract law, and organization theory), have had a keen interest in public policy, and have made a point of deriving refutable implications to which empirical testing can be applied. The main project that I have been involved with during the past 35 years is variously described as transaction cost economics, the new institutional economics, and the economics of governance. This last is both the most specific and operationally significant description of the project. By way of perspective, governance is nested within transaction cost economics, which in turn is subsumed within the new institutional economics.

So what is governance? I describe governance as the means by which to infuse order, thereby to mitigate conflict and realize mutual gains from trade, which is broadly in the spirit of James Buchanan's remark that "mutuality of advantage from … [contract is] the most fundamental of all understanding in economics."[1] Governance, so described, is a lens of contract construction.

That the economics of governance is different is evident by posing and discussing four questions. I ask that you consider these questions from two different points in time, today and 35 years ago. The four questions are these:

1. Should economists describe human actors in more veridical terms?
2. Should prominent provision be made for positive transaction costs (which, broadly, are the costs of running the economic system)?
3. What is the central problem of economic organization?
4. Beyond the gains from trade that accrue to simple market exchange, do ongoing contractual relations pose additional issues of analytical and public policy importance?

I venture that many economists would answer these questions today as follows:

1. Yes, there is increasing agreement that the limits on human cognition and the existence of strategic behavior need to be taken into account.

2. Yes, positive transaction costs are consequential.
3. A central problem of economic organization is adaptation.
4. The actual and prospective breakdown of ongoing contractual relations is economically important and poses added conceptual and analytical challenges.

These answers are usefully contrasted with those of 1970, when most economists would have answered as follows.

1. The economic man of orthodox economic theory – who is supremely rational and myopically self-interested – works just fine.
2. Transaction costs can be presumed to be zero.
3. The central problem of economic organization is efficient resource allocation.
4. Ongoing contractual relations are a needless distraction.

Lest I be misunderstood as an unsympathetic critic of orthodoxy, let me state that I agree that textbook orthodoxy has been and is informative. Economics, today, however, is less of a unified science than it was 35 years ago. The economic theory of firms and markets (singular) has been replaced by theories of economic organization (plural). Thus although orthodoxy occupies a big space, there is both room and need for new perspectives. Pluralism is what we have now and is what I project for the next decade.

The new theories that have come into place over the past 35 years have both conceptual and empirical origins. Salient among the empirical realities were the crisis in public policy toward business within the U.S. during the 1960s – which crisis is traced by Ronald Coase, correctly I think, to the prevailing all-purpose reliance on price theory to explain deviations from simple market exchange. Technology aside, monopoly purpose and effect had become the obvious explanation for nonstandard contractual practices and organizational structures: "when an economist sees something that he does not understand, he looks for a monopoly explanation. And as in this field we are very ignorant, the number of ununderstandable practices tends to be rather large, and the reliance on a monopoly explanation frequent."[2] Good humor, to be sure, but also, sadly, an accurate description of antitrust policy. Something had to be done to bring relief from the one-string banjo of monopoly reasoning. It takes a theory to beat a theory, however. Awaiting a new theory, monopoly claims proliferated.

A more recent and more dramatic reminder that our theories of economic organization were out of touch with reality was the collapse of communism in Eastern Europe and the former Soviet Union. That this should come as a surprise to the intelligence communities and to specialists in comparative economic systems and area studies is unsettling. Where had our understanding of economic organization gone wrong? Such a massive disconnect suggests the need for new and different lenses.

The new economics of organization actually provides several lenses rather than one. The main divide is between theories of incentive alignment and theories of ongoing governance. The economics of governance on which I have been working is plainly of the latter kind. The object is to work up a logic of economic organization that explains which modes of organization – spot markets, long-term contracts, firms, regulation, public bureaus, nonprofits, and the like – are used to manage which activities and why. A predictive theory of economic organization is the object.

Recalling "today's answers" to the questions that I set out earlier (which answers are also congruent, I think, with our intuitions and experience), we have reason to believe that cognition, adaptation, and transaction costs all matter. But that does not suffice. Skeptical economists are right to insist that they be shown how and why.

The four precepts of "pragmatic methodology" are a good place to start: keep it simple; get it right; make it plausible; and derive refutable implications to which the data can be applied.[3] My interpretation of these is as follows: keep it simple is made necessary by the very complexity of economic organization, whereupon we need to get to the essence and focus on the "main case"; get it right means to work out the logic; make it plausible means to eschew fanciful constructions; and prediction and testing is the way that we sort the sheep from the goats as among would-be theories. These precepts have served economics well in the past and I believe will continue to do so for the future.

My purpose here is to sketch how the economics of governance helps to pour economic meaning into our understanding of human actors, of organization, of transaction costs, and of efficient (and inefficient) governance, broadly in the spirit of pragmatic methodology.

Herbert Simon's advice to social scientists is unequivocal: "Nothing is more fundamental in setting our research agenda and informing our research methods than our view of the nature of the human beings whose behavior we are studying."[4] Cognition is a key human attribute, where Simon takes exception with the assumption that human actors are supremely rational and advises that they should be described instead as boundedly rational – by which he means intendedly rational but only limitedly so. Yet what are we to make of this?

Increasing interest in bounded rationality seems to be converging in the following: the ramifications of bounded rationality vary with the context. In the context of complex board games (such as chess), bounds on rationality induce us to rely on heuristics. In the context of contracting, we need to come to terms with the fact that all complex contracts are unavoidably incomplete.

No surprise with this last you say? Of course long-term contracts are incomplete. Too many things can go wrong. Rather than attempt to cross all possible bridges in advance, many are crossed if and as they appear.

That is not, however, the way that the economics of contract worked. We had a theory of simple market exchanges on the one hand and a theory of complex complete contingent claims contract on the other. Neither admitted to contractual incompleteness.

To be sure, incompleteness was not a problem for simple market exchange, which was the ideal transaction for both law and economics: "sharp in by clear agreement; sharp out by clear performance."[5] But not all transactions are so described. Upon recognizing that our cognitive limits as human actors preclude comprehensive contracting and that ongoing contractual relations are frequently the source of mutual gain, something needed to be done.

One possibility was to invoke "contract as promise," in the hope that promises to behave cooperatively when the unforeseen materialized would be self-enforcing. That asks a lot, however, of the frailties of human actors. Thus although the parties to a long-term contract have an interest in seeing the contract go successfully to completion, they are also aware that individual advantages can sometimes be realized by defecting from the spirit of cooperation and reverting to the letter of the contract. So while most people will do what they say (and some will do more) most of the time, provision also needs to be made for outliers, where the stakes are great. The upshot is that self-interested bargaining of an opportunistic kind is the exception to which cooperation is the rule. Such exceptions are nonetheless important: they introduce strategic considerations that had too long been suppressed in the study of contract and organization (and economics more generally).

The economics of governance expressly makes provision for contractual hazards that have their origins in contractual incompleteness (bounded rationality) in conjunction with possible contractual defections (opportunism). But it does not wring its hands over that. Efficient governance lessons reside therein. Out of awareness of the potential for contractual breakdown, the lesson is to look ahead, uncover the hazards, ascertain the mechanisms through which they operate, and factor these back into the original contract design – by crafting contractual safeguards, such as penalties for breach, information disclosure and verification mechanisms, and specialized dispute settlement mechanisms (such as arbitration). In the limit, as contractual hazards proliferate and efforts to craft credible commitments become progressively more costly, transactions are taken out of markets and organized internally, where a different mode of governance – the firm, which employs hierarchical coordination mechanisms – can be brought to bear.

By contrast with orthodox interpretations of non-standard and unfamiliar contracting practices and organizational structures in the 1960s, where these were believed to have monopoly purpose and effect, the economics of governance reveals that many of these practices and structure are undertaken for an altogether different reason: hazard mitigation, which is the source of mutual gain and leads to efficiency.

One of the factors that explains why the economics of governance and orthodoxy differ is that the former works out of a more exploratory and the latter out of a more declamatory approach to economic organization. Rather than self-confidently pronounce that "this is the law here" by appealing to price theory, the economics of governance instead asks the question, "What is going on here?", whereupon the details of contract and organization come under scrutiny.

With reference to the latter, this leads into two further questions: What is the main purpose of economic organization? And how do alternative modes of governance differ from each other?

Both Friedrich Hayek, the famous economist, and Chester Barnard, the famous organization theorist, agreed that adaptation is the central problem of economic organization.[6] But whereas Hayek emphasized autonomous adaptations undertaken by firms and individuals in the market, Barnard emphasized coordinated adaptations of a conscious, deliberate, purposeful kind using administrative processes within firms. It being the case that high performance economic systems display adaptive capacities of both kinds, there is a need for both markets and hierarchies. Which will be used where will depend on the nature of the activity to be organized (which vary with transactions, to which I will return later). Suffice it to observe here that the economics of governance subscribes to the proposition that adaptation is the central problem of economic organization and makes express provision for both autonomous and coordinated adaptation.

The ramifications for orthodoxy are illustrated by Harold Demsetz's observation that is "a mistake to confuse the firm of [orthodox] economic theory with its real-world namesake. The chief mission of neoclassical economics is to understand how the price system coordinates the use of resources, not the inner working of real firms."[7] Price system coordination occurs spontaneously (the invisible hand) and is autonomous, in that each individual firm responds to what it perceives as market opportunities, as reflected by market prices. By contrast, the inner workings of real firms achieve purposeful coordination through the use of hierarchy. Accordingly, whereas the firm of neoclassical theory is a technological construction, whereby inputs are transformed into outputs according to the laws of technology, the economics of governance is an organizational construction, in that the structure (or architecture) of the firm and the management mechanisms through which it operates both matter. The upshot is that markets and hierarchies are alternative modes of governance that differ in kind, which differences were emasculated by the orthodox setup.

Consider now the third question: Do we need to make a prominent place for transaction costs? Our provisional answer to this question was yes, but now we need to explain what we mean by transaction costs.

Kenneth Arrow described transaction costs as “the costs of running the economic system.”[8] He also observed that whereas orthodoxy assumed that transaction costs were zero, the existence of many phenomena, of which vertical integration is one, suggested otherwise. The question nevertheless remains as to what we mean when we say that transaction costs are positive.

As it turns out, transaction costs can take many forms: search costs, measurement costs, shirking costs, bargaining costs, information processing costs, maladaptation costs, and the list goes on. Among these costs, the challenge is to identify which are the more important and to bring these to operational life.

My reference to operationality is crucial. A chronic problem with the concept of transaction cost is that it was vague and malleable. As a result, any puzzling economic phenomenon could be and often was explained after-the-fact by invoking suitable transaction costs – which is undisciplined and unacceptable.

The economics of governance responds to this challenge by yoking the concept of transaction cost with that of governance – where, to repeat, governance is the means by which to infuse order, thereby to mitigate contractual hazards and realize mutual gains from trade. Specifically, the economics of governance names maladaptation costs as the main class of transaction costs on which to focus. Adaptation being the principal purpose of economic organization, maladaptation is where the principal transaction costs reside.

Infusing order, thereby to relieve maladaptation and realize mutual gain, is achieved by application of the discriminating alignment hypothesis. Differences in transactions and among modes of governance are key. Specifically:

(1) If some transactions are simple and some are complex, then the attributes of transactions that are responsible for these complexity differences must be named and their ramifications set out. (This is not the time or place to go into these differences – except to say that contractual complications, not engineering complications, are where the key differences reside.)

(2) If the comparative efficacy of different modes of governance (market, hybrid, hierarchy, public bureau, etc.) differ, then the critical attributes that describe alternative modes of governance needs to be named and the internally consistent syndromes of attributes that define viable modes need to be worked out.

(3) Finally, transactions and governance need to be joined. This takes the form of the discriminating alignment hypothesis, to which a predictive theory of economic organization results: transactions, which differ in their

attributes, are aligned with governance structures, which differ in their cost and competence, so as to effect a transaction cost economizing outcome. The adaptive needs of transactions are thus matched to the adaptive capacities of alternative modes of governance. The upshot is that there is a place for markets, hierarchies, bureaus, etc., and each is kept in its place.

The foregoing provides you with a sketch of what the economics of governance has been up to. I hope in the process that I have provided you with a basis to answer each of the questions that I put to you at the outset. But I would be remiss in failing to remind you that doing the economics of governance comes at a cost. Indeed, those who decide to examine economic organization through the lens of contract/governance will incur costs of three kinds.

The first cost is that the economics of governance is an interdisciplinary undertaking in which both law (especially contract law) and organization theory are selectively combined with economics. If and as the problems of economic organization spill over beyond the familiar boundaries of economics, the student of governance must be prepare to follow them – lest meaningful contact with the phenonomena be sacrificed (which is precisely what explains the crisis in public policy toward business in the pre-transaction cost era).

The second cost is that the student of governance needs to examine economic organization in much greater detail than had been customary. This collides with the view that to expound on the details will obscure the basic issues, to which I respond as follows: among the myriad of details, we need to focus on those that are pertinent. This is why the attributes of transactions and the mechanisms of governance are examined through the focused lens of transaction cost economizing.

And third, I have merely sketched the main moves and have done this in a very broad brush way. Not only are there many nuances and qualifications, but the economics of governance works off of an additional set of bridging moves – of which the Fundamental Transformation is the most important – the explication of which is too technical to go into here.[9]

More generally, the economics of governance is still a work-in-progress. If and as others agree, the economics of governance is an unfinished project whose time has come. I hope that future awards of the Horst Claus Recktenwald Prize in Economics will reflect such follow-on work.

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