A Commentary and Response on Noorderhaven: The Argumentational Texture of Transaction Cost Economics

On the Incompatibility of Opportunism and Unified Governance

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A recent article in this journal (Noorderhaven 1995) claims that the assumption of opportunism in transaction cost economics is problematic. It is concluded from analyzing *Economic Institutions of Capitalism* (Williamson 1985) by using the deconstruction method that 'actors have to be assumed to be both opportunistic *and* non-opportunistic if the logic of the theory is to be maintained'. This note deconstructs this conclusion by formulating a counter-example in the form of the incomplete contracting literature.

There is complete agreement with Noorderhaven that it is not acceptable in the formulation of a theory to switch behavioural assumption(s) in order to be able to compare one governance alternative with another. This is an old criticism levelled at organization theories. For example, Coase (1937) and Simon (1951) stress the beneficial effects of selective intervention in order to eliminate problems associated with market exchange. The argument is that activities of subordinates can be directed within organizations, but that they cannot when market exchange is involved. If this is the only driving force behind the existence of organizations, then all markets will disappear and only one large organization governing all exchanges will come into existence. Similarly, Alchian and Demsetz (1972) asked the question of how the approach by Coase and Simon can distinguish between an employee–employer relationship and a grocer–customer relationship.

The seminal contribution by Grossman and Hart (1986) maintains the assumption of bounded rationality throughout the analysis. It starts with the observation that meaningful contracts can only be based upon observable and verifiable variables. The behavioural assumption guiding decision makers is opportunism. Their goal is to investigate how: 'Behavior changes when one of the self-interested owners becomes an equally self-interested employee of the other owner'.

Different governance structures are investigated regarding the incentives they induce. Integration brings costs as well as benefits. Benefits arise from reducing opportunistic behaviour and hold-up problems. The idea is that:

'Transferring ownership of an asset from party 2 to party 1 increases 1's freedom of action to use the assets as he or she sees fit and therefore increases 1's share of

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ex post surplus and ex ante incentive to invest in the relationship; but 2's share of ex post surplus and incentive to invest falls.' (Hart and Moore 1990)

Vertical integration is predicted when the investment decision in the relationship by one party is much more important than the other party's investment decision and the over-investment decision by the employer is a less severe problem than the under-investment decision of the employee. Market exchange is desirable if both parties are important, i.e. medium levels of investments of both parties are preferred compared to a situation in which one party has a very high and the other a very low investment level under integration. This approach follows the advice of the Coase theorem (1960) in focusing on bargaining problems and wealth constraints to explain the allocation of ownership in a world inhabited with opportunistic individuals. Issues addressed in the incomplete literature are the size of the organization, ownership and indispensability, and joint ownership of assets (Hart and Moore 1990); influence costs (Milgrom and Roberts 1988); financial governance (Aghion and Bolton 1992); the scope of diversification (Rotemberg and Saloner 1994); formal and real authority in organizations (Aghion and Tirole 1994); and partnerships (Halonen 1994).

Hart and Moore (1990) reconcile the position of Coase and Simon with the position of Alchian and Demsetz. This is done by defining ownership in terms of control over physical assets. Control cannot be exercised explicitly over human assets, because they are inalienable. However, implicit control over an employee can be exercised by the owner of the physical assets because of his ability to exclude others from the use of these assets in situations where the productivity of the human capital of an employee depends on the availability of these physical assets. This resolves the well-known criticism that Alchian and Demsetz (1972) made on Coase's (1937) paper. They argued that the employer–employee relationship is no different from the customer–grocer relationship, i.e. an employer can 'fire or sue, just as I can fire my grocer from stopping purchases from him or sue him for delivering faulty products'. A grocer is more likely to follow the wishes of the customer when he is an employee of the latter than when he is an independent contractor, because in the former case the customer owns the assets, e.g. the grocery store with which the grocer intends to work, whereas in the latter case, the customer does not.

Williamson (1985) refers to an unpublished version of Grossman and Hart (1986). Subsequently he has repeatedly indicated that two streams of research in economics are promising regarding the theorizing about organizations. (For a recent statement, Williamson 1994 can be consulted.) The first stream of research is the incomplete contracts literature. The second line of research approaches the firm as a system of attributes between which complementarities are to be exploited (e.g. Milgrom and Roberts 1990; Holmström and Milgrom 1994). Mainly employing natural language has the advantage that its flexibility leaves many possibilities for delineating non-standard forces which are important for the understanding of organizations, whereas insufficient progress in the design of formal tools/concepts may render an account of such forces impossible. However, the strength of natural language is also its weakness. Vagueness and ambiguity is inherent to it and may distract away from the main message that one wants to convey, or it may be hard to imagine how one aspect, e.g. opportunism, operates in different environments, e.g. different institutions. Noorderhaven (1995) seems to be an example of the latter, i.e. just focusing on a natural language account of transaction cost economics may give the impression that opportunism in transaction cost economics is suitable for analyzing the (dis)advantages of market exchange, but not for unified governance. The above counter-example, in terms of the incomplete contracting literature, elegantly shows the differential impact of the behavioural assumption of opportunism in different institutional settings.

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