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Review

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Rogoff, K. (1985) 'Can international monetary policy cooperation be counter-productive?' *Journal of International Economics* 18, 199–217

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The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting by Oliver E. Williamson. New York: The Free Press, 1985. Pp. xiv + 450. Index. ISBN 0-02-034820-X

Ten years ago, Oliver Williamson published a remarkable book entitled *Markets and Hierarchies* in which he explored the efficiency properties of alternate contracting modes and the significance of hierarchies within the modern business firm. The book was an important complement – some would say corrective – to the neoclassical emphasis on the firm as a production function, driven in the pursuit of profit maximization by technological and market imperatives. Williamson's broader view of the firm directed attention to its internal organization and its interpretation as an alternative to market exchange for a wide range of economic functions, the choice of market or firm depending primarily on relative efficiency considerations. The book has since become a classic in the literature of transaction cost economics and comparative institutional analysis. Williamson's continuing refinement of this theme culminates in *The Economic Institutions of Capitalism*.

Williamson's book is well worth reading for economic and business historians. But it is not easy reading; for he relies on a style of verbal theorizing that is often dense and difficult to penetrate. And before many readers can even get started, they will have to learn a new vocabulary. To begin, the basic behavioural assumptions are bounded rationality (i.e., 'rationality constrained by cognitive abilities' compared with the economist's usual insistence that rational behaviour requires all costs and prices be known) and opportunism (i.e., 'self-interest seeking with guile' rather than the full disclosure of initial positions, called by Williamson simple self-interest, favoured by most economists). The fundamental micro-economic unit is now the transaction, and differences in transactions are explained by asset specificity (represented by investments in sites, equipment, and skills) which leads away from the traditional emphasis on differences between fixed and variable costs to classifying assets as either transaction-specific or redeployable. Asset specificity gives rise to the fundamental transformation, whereby hierarchical relationships and internal governance structures take precedence over market exchanges.

Williamson's behavioural postulates and analytical framework are in many ways more congenial to the historian than is the neoclassical theory of the firm. Cognitive competence does place limitations on economic man; information asymmetry is a source of uncertainty; and the notion that governance

structures evolve 'to organize transactions so as to economize on bounded rationality while simultaneously safeguarding them against the hazards of opportunism' (32) does yield a rich and insightful conception of the economic problem.

Moreover, historians will find compelling Williamson's application of transaction cost economizing to a wide range of issues in economic organization – vertical integration, corporate governance, antitrust policy, the organization of work, and labour unions – especially since he frequently cites historical examples drawn from familiar authors like Alfred D. Chandler Jr, whose works (e.g., *Strategy and Structure*, 1962; *The Visible Hand*, 1977) represent the current state of the art in American business history.

Take the case of vertical integration, for example. According to Williamson, vertical integration occurs selectively, as less efficient modes of organizing transactions are replaced by more efficient ones. Many of Chandler's examples of forward integration from the railway sector in the late nineteenth century can be recast as examples of transaction cost savings owing to asset specificity (e.g., refrigerated railway cars) that could not be achieved under market conditions. Again, when analysing the evolution of corporate governance, Williamson provides a convenient taxonomy for assessing efficiency across the broad spectrum of modes of ownership and contract, from the Putting Out System to the Authority Relation (a pseudonym for the modern capitalist firm), and concludes that successive modes have evolved because of their superior efficiency characteristics. (Missing, however, is any attempt to assess the relative importance of the efficiency criteria.)

Using Chandler as a basis for illustration, Williamson argues that the emergence of the modern corporate form was the product of a series of organizational and administrative innovations that economized on transaction costs and influenced the size and shape of the firm. The emergence of the multidivisional managerial structure in the 1920s, for example, with its semi-autonomous operating divisions and a general office responsible for internal control and strategic planning, was celebrated by Chandler as a response to the limitations associated with the earlier unitary structure; its appearance is interpreted persuasively by Williamson in transaction cost terms.

Alternatively, consider Williamson's discussion of antitrust policy. Here, he summarizes the changing underpinnings of merger policy, from a predominant concern with entry barriers and market power in the 1960s to a greater appreciation of economic efficiency in the 1980s, particularly the existence of trade-offs between market power and efficiency and of economies due to transaction cost savings (as well as technological gains). He cites two examples of interest, one from the Canadian petroleum industry where he instances the controversy over the relative importance of marketing and entry restraints and efficiency gains, the other an extended discussion of the efficiency principles governing cable television franchising in Oakland, California.

Williamson's prescription for empirical research is straightforward and unexceptionable: identify the relevant transaction cost dimensions (usually where market trading is not observed); describe alternative modes for organizing these transactions; assess the comparative efficiency of the organizational alternatives. Granted this strategy has broad applicability, to both current and historical problems, there remain significant empirical gaps in our knowledge of institutional change. Even with clear evidence that governance structures conform to the predictions of theory, can transaction cost savings be measured? What is the relative importance for efficiency gains of technological and market factors on the one hand, and changes in governance structure on the other? Whether empirical studies will soon fill in the missing information is a moot point. But Williamson is well aware of these issues, and he has provided us with a persuasive conceptual apparatus as a route map to their solution.

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