12. A New Institutional Approach to Organization

CLAUDE MENARD

1. INTRODUCTION

Modern economic theory has long neglected, even ignored, the analysis of the different modes of organization that characterize a market economy. Notwithstanding the efforts of Alfred Marshall, one of its founding fathers, in identifying the properties of "business organizations" (1920, Book IV, chap. 10 sq.), standard microeconomics relied for decades on the concept of firms as production functions, an umbrella to the technologically determined combination of inputs.

This situation has changed under the influence of the celebrated paper by Coase on "The Nature of the Firm" (1937). There are now several alternative theories of organization in economics[1], with "transaction cost economics", "agency theory", "property rights theory", and a mix of resource-based and evolutionary perspective as the leading approaches.[2] Beyond serious divergences, this diversity of approaches is striking. The development of competing explanations reflects an increasing interest for the nature of organizations. This becomes particularly obvious when looking at the resurgence of the literature on the theory of the firm, but also at the booming number of papers on other modes of organizations, e.g., strategic alliances, joint ventures, etc. However, it also suggests that we still miss an integrated theory.

This chapter reviews what we have learned and some unsolved problems about alternative modes of organization. It does so by focusing almost exclusively on contributions rooted in the new institutional approach, which is

[1] The analysis of organization actually developed initially in other disciplines, generating a field of its own (Organization Theory).

[2] The hard core of these theories can be summarized as follows. Transaction cost focuses mostly on explaining the existence and properties of alternative modes of organization and the tradeoffs among them. Agency theory primarily examines incentives, i.e., the way a principal can induce agents to behave according to his interest. The property rights paradigm, "old" or "new", centers on ownership and the related allocation of decision rights as a determinant for understanding relationship-specific investments. The resource-based–evolutionary view explores mainly how organizations develop internal characteristics, such as routines and know-how, in order to deal with their environment. Gibbons (2004) proposes a slightly different typology.

C. Ménard and M. M. Shirley (eds.), Handbook of New Institutional Economics, 281–318.

primarily based on transaction cost economics. Notwithstanding significant intersections, I refer to alternative explanations only marginally. My analysis centers on modes of organization understood as institutional arrangements within which a transaction or a set of related transactions are decided upon and then implemented.

Therefore, the perspective adopted is in the continuation of Coase and Williamson. I assume the existence of alternative ways of organizing relationships among economic units in order to take advantage of the division of labor while economizing on bounded rationality and safeguarding parties against contractual hazards. Coase grouped these arrangements under the expression "institutional structure of production", while Williamson speaks of "mechanisms of governance".[3] In what follows, I capture the same ideas under the generic expression "modes of organization". My analysis is grounded in the golden triangle defining New Institutional Economics (NIE): transaction costs, contracts, and property rights. Transaction costs provide an explanation to the existence of alternative modes of organization as well as tools for understanding the characteristics of these arrangements. Contracts represent a focal point in NIE because of their role in relaxing the constraints of bounded rationality, fixing schemes of references for future actions, and checking on opportunistic behavior. Lastly, relatively well-defined property rights, and institutions for implementing them, form a prerequisite for making the transfer of rights possible and the trade-off among arrangements meaningful. Property rights thus affect contractual hazards and embed transactions into specific institutional environments. However, in what follows I focus exclusively on the micro level, with no specific analysis of embedding issues.

More precisely, this chapter reviews different modes of organization, from integrated firms to hybrids and markets. A clarification is needed here. 'Market' is not a simple term and this often creates confusion. On the one hand, it delineates a mode of organizing exchanges, with spot markets as the archetypical example, as opposed to exchanges arranged, say, within a firm. On the other hand, in a market economy 'market' designates the set of institutions that embed all modes of organization since they all have to go through or be confronted to markets at some point. In this chapter I focus mainly on the first and relatively narrow sense.[4]

My presentation is organized as follows. Section 2 summarizes the fundamental story behind the new institutional approach to organization. Section 3 reviews specific characteristics of firms and more generally of integrated organizations in a transaction cost perspective. Section 4 examines characteristics of a variety of arrangements, the hybrid forms, long ignored by economic theory and now at the forefront of a substantial body of research. Section 5 turns to the analysis of markets as a mode of organization and challenges the idea that

[3] Referring to John Commons, Williamson defines governance structures as ways to implement order for facing potential conflicts that could threaten opportunities to realize mutual gains (1996, Prologue, p. 12)

[4] More on this in section 5.