2. The Institutional Structure of Production[1]

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In my long life I have known some great economists, but I have never counted myself among their number nor walked in their company. I have made no innovations in high theory. My contribution to economics has been to urge the inclusion in our analysis of features of the economic system so obvious that, like the postman in G. K. Chesterton's Father Brown tale, "The Invisible Man," they have tended to be overlooked. Nonetheless, once included in the analysis, they will, as I believe, bring about a complete change in the structure of economic theory, at least in what is called price theory or microeconomics. What I have done is to show the importance for the working of the economic system of what may be termed the institutional structure of production. In this lecture I shall explain why, in my view, these features of the economic system were ignored and why their recognition will lead to a change in the way we analyze the working of the economic system and in the way we think about economic policy, changes which are already beginning to occur. I will also speak about the empirical work that needs to be done if this transformation in our approach is to increase our understanding. In speaking about this transformation, I do not wish to suggest that it is the result of my work alone. Oliver Williamson, Harold Demsetz, and Steven Cheung, among others, have made outstanding contributions to the subject, and without their work and that of many others, I doubt whether the significance of my writings would have been recognized. While it has been a great advantage of the creation of the Prize in Economic Sciences in Memory of Alfred Nobel that, by drawing attention to the significance of particular fields of economics, it encourages further research in them, the highlighting of the work of a few scholars, or, in my case, one scholar, tends to obscure the importance of the contributions of other able scholars whose researches have been crucial to the development of the field.

I will be speaking of that part of economics which has come to be called industrial organization, but to understand its present state, it is necessary to say something about the development of economics in general. During the two centuries since the publication of *The Wealth of Nations*, the main activity of economists, it seems to me, has been to fill the gaps in Adam Smith's system, to correct his errors, and to make his analysis vastly more exact. A principal theme

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of *The Wealth of Nations* was that government regulation or centralized planning were not necessary to make an economic system function in an orderly way. The economy could be coordinated by a system of prices (the "invisible hand") and, furthermore, with beneficial results. A major task of economists since the publication of *The Wealth of Nations*, as Harold Demsetz (1988, volume I, page 145) has explained, has been to formalize this proposition of Adam Smith. The given factors are technology and the tastes of consumers, and individuals, who follow their own interest, are governed in their choices by a system of prices. Economists have uncovered the conditions necessary if Adam Smith's results are to be achieved and where, in the real world, such conditions do not appear to be found, they have proposed changes which are designed to bring them about. It is what one finds in the textbooks. Harold Demsetz has said rightly that what this theory analyzes is a system of extreme decentralization. It has been a great intellectual achievement, and it throws light on many aspects of the economic system. But it has not been by any means all gain. The concentration on the determination of prices has led to a narrowing of focus which has had as a result the neglect of other aspects of the economic system. Sometimes, indeed, it seems as though economists conceive of their subject as being concerned only with the pricing system and anything outside this is considered as no part of their business. Thus, my old chief and wonderful human being, Lionel Robbins, wrote, in *The Nature and Significance of Economic Science*, about the "glaring deficiencies" of the old treatment of the theory of production with its discussion of peasant proprietorships and industrial forms: "It suggests that from the point of view of the economist 'organisation' is a matter of internal industrial (or agricultural) arrangement—if not internal to the firm, at any rate internal to 'the' industry. At the same time it tends to leave out completely the governing factor of all productive organisation—the relationship of prices and cost . . . (Robbins, 1932, page 70). What this comes down to is that, in Robbins's view, an economist does not interest himself in the internal arrangements within organizations but only in what happens on the market, the purchase of factors of production, and the sale of the goods that these factors produce. What happens in between the purchase of the factors of production and the sale of the goods that are produced by these factors is largely ignored. I do not know how far economists today share Robbins's attitude but it is undeniable that microeconomics is largely a study of the determination of prices and output; indeed, this part of economics is often called price theory.

This neglect of other aspects of the system has been made easier by another feature of modern economic theory—the growing abstraction of the analysis, which does not seem to call for a detailed knowledge of the actual economic system or, at any rate, has managed to proceed without it. Bengt Holmstrom and Jean Tirole (1989) writing on "The Theory of the Firm" in the recently published *Handbook of Industrial Organization*, conclude at the end of their article of 63 pages that "the evidence/theory ratio . . . is currently very low in this field" (page 126). Sam Peltzman (1991) has written a scathing review of the *Handbook* in which he points out how much of the discussion in it is theory