

"The old order changeth, yielding place to new."

Alfred, Lord Tennyson
Morte D'Arthur

Presently unfolding in the Soviet Union and its former satellites is a drama of monumental importance to global society, both in the present, and in the future. The 70 year long economic order imposed through central planning is changing, but what the new order might be is not yet clear. As communist social assumptions are discarded in favor of capitalist norms, entire societies launch headlong into uncharted waters in which rapid conversion to a market economy is a societal imperative. A most significant consequence of this conversion is the swift and often painful disaggregation of the command economic system.

**FROM HIERARCHY TO MARKET:
MITIGATING SOCIETAL IMPACTS OF GOVERNANCE TRANSITION
IN THE MACRO INSTITUTIONAL SETTING**

Ronald K. Mitchell
University of Utah

David Eccles School of Business
Salt Lake City, UT 84112
801/581-5633
(Fax) 801/581-7214

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The problems faced by these countries are exacerbated by "... the rigidity of the past system, the lack of clarity and problems associated with a new system, and the inevitable disruptions when the two systems meet" (Ivanovich et al., 1992: 48). In the case of Hungary, for example, the management practices characteristic of the old order have resulted in waste and inefficiency characterized by "... excessive bargaining between supervisors and subordinates, pervasive distrust, the de-legitimation of managers, and responsibility avoidance" (Pearce, 1991: 75). Further, the fear of expropriation bred during an "era of confiscations" (Kornai, 1986: 1705) does little to assuage the reluctance of craftsmen and shopkeepers to engage in anything but "myopic profit maximization" (1986: 1706).

It is not surprising that the historical uniqueness of the circumstances, when combined with the rapidity with which events continue to unfold yields a public policy crisis in Eastern Europe and in the former Soviet Union. Guidelines are urgently needed which can assist economic actors in these countries in mitigating the economic dislocations and attendant chaos which accompany the movement to a market economy. Transaction cost economics offers such guidelines.

In the case of the former command economies, firms exist as a consequence of the past and present influence of the organizational framework employed under the economic assumptions of central planning. The aggregation of certain assets within the boundary of firms, and of those firms within the boundary of a macro-institutional entity (GOSPLAN for example), was a very similar hierarchical system to those which are described and illuminated by the study of transaction cost economics. Transaction cost economists argue that the preoccupation of traditional economists with pricing, overlooks more fundamental, "first order economizing" (Williamson, 1991b: 78). Attention to first order economizing offers substantial potential benefit both to business and to society. Where first order (efficiency) economizing is directly compared to second order (price) economizing, the gains possible from first order economizing may "easily be on the order of 10:1" (Williamson, 1991b: 79).

This paper explores the conditions under which the principles of transaction cost economics may be productively applied to the transition of command economies from the command hierarchy to a market system. The paper is organized in four parts. The first section outlines the rudiments of transaction cost economic theory as it applies to capitalist v. command economies. An interpretation of first order economizing issues which arise in the transition from hierarchy to market is advanced in the second section, along with four propositions which flow from the arguments. Possible applications of this framework are sketched in the third section. In the fourth, proposed benefits of this approach, along with concluding remarks are presented.

TRANSACTION COST ECONOMICS: A COMPARATIVE APPROACH

A Capitalist Economy Application

A fundamental tenet of transaction cost theory is that firms form where markets fail (Coase, 1937). Under this conception, the firm is defined "... by the ideas of margin (boundary) and substitution, developed by Marshall (1921), together giving the ideas of substitution at the margin" (Coase, 1937: 387). Thus, the principles of transaction cost economics rest upon the notion of the comparative economic governance of firms, which in turn rests upon the concept of substitution at the margin. Substitution at the margin may be considered to be first order economizing because it consists of simply saving or economizing on the overall costs of a transaction through the adjustment of transactional governance.

Transaction cost economists have long argued that assets are internalized within a firm due to market failure; that as previously stated: firms form where the market fails (Coase, 1937). More specifically Coase states:

"Outside the firm, price movements direct production, which is coordinated through a series of exchange transactions on the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-coordinator who directs production" (Coase, 1937: 388).

This substitution, or *fundamental transformation* occurs when transactions take place under conditions of asset specificity, where bounded rationality, opportunism, uncertainty, and frequency characterize the transacting environment (Williamson, 1985). Essentially, where assets have a substantially lower value under alternative uses (the working definition of asset specificity, Williamson, 1985), contracting for their employment is reduced from large numbers bargaining (fully contestable, price mediated market transacting), to small numbers bargaining (bilateral transacting), requiring an alternative governance structure (e.g. a firm/hierarchy) to safeguard the transaction. Without this protection, premature contract termination would cause an expropriation of the difference in value between the

expected value for use of the asset in a given transaction, and its value under alternative employment. The use of a governance structure to economize on these transaction costs constitutes the definition of efficiency in economizing; the *relative* minimization of which explains the existence of firms.

Transaction costs may also arise *within* a firm, although transaction costs in this context are characterized as failures of alignment v. failures of a market (Williamson, 1991b). More specifically, they are described as:

"Excesses of waste, bureaucracy, slack, and the like ... (which arise) ... because first order economizing alignments are not always obvious and/or sometimes are at variance with managerial preferences" (interpreted herein as internal substitutions at the margin) (Williamson, 1991b: 79).

Differences among firms, including their propensity to fail (disaggregate), then, may be explained in terms of first order economizing.

Hence, within the capitalist economic system, transaction cost economic theory defines two elements of first order economizing: (1) autonomous economizing, which describes substitutions of hierarchies for markets due to market failure, and (2) coordinative economizing, which describes the substitution of one firm for another due to alignment failure (Williamson, 1991b).

A Command Economy Application

Application of transaction cost economics to the study of command economies is a natural extension of its application in capitalist economies. A basic contention of transaction cost economics is that transactions are internalized where they are less efficiently handled between firms (in a market), and that "this necessarily means replacing markets with non-market mechanisms (hierarchies)" (Sacks, 1988: 865). Through slight modifications, "... substantial insight into changes taking place in socialist countries around the world can be gained" (Sacks, 1988: 865). For the purpose of autonomous first order economizing, these modifications consist mainly of considering the question of internalization in reverse, i.e. conceiving of the circumstances under which transactions would move from *hierarchy to market*. In a recent discussion of transaction cost economics and planning failure, application of the transaction cost paradigm to the Soviet economic organization was described as follows:

"To apply the transaction cost framework to the study of Soviet economic organization, the central (transaction cost) question must be posed in reverse: What factors induce a shift of transactions from the planning hierarchy to decentralized modes of organization?" (Kroll, 1988: 858).

Essentially, then, the view of the command economy as a type of hierarchy created as a consequence of "... an ideology that historically has rejected the market in favor of central planning" (Kroll, 1988: 857), is not inconsistent with the basic tenets of the transaction cost paradigm. In fact, some writers describe the command economy quite directly in transaction cost economic terms:

"The command economy is organized as a hierarchy, with the national political leadership at the top, production units at the bottom, and several layers of economic and political authority in between" (Kontorovich, 1988: 879).

Accordingly, this paper contends that transaction cost economics may inform the study of command economies, and in particular, provide a template by which policy makers can more accurately apprehend, interpret, and act upon the underlying economic components essential to a successful transition to a market economy. It further argues that attempts to move to a market economy, and to attenuate the adverse effects of this transition may be better understood through attention to first order economizing decisions in both autonomous and coordinative situations. It is toward a first order economizing interpretation of the transition from hierarchy to market that attention is now directed.

TRANSITION AND FIRST ORDER ECONOMIZING

It is the central thesis of this paper that in the transition of command economies from hierarchy to market, firms need not fail when the market forms. Using the principles of transaction cost economics, it is distinctly possible to envision the creation of markets without necessarily requiring the failure of firms. This, first, because autonomous economizing has the potential to guide decisions regarding efficient firm boundaries; and second, because coordinative economizing can be undertaken within firms to eliminate waste, thereby enhancing both societal welfare (Williamson, 1991b), and the survival of firms.

Transaction cost economists argue that the conditions under which the fundamental transformation occurs are pervasive within the transacting environment (Williamson, 1985). Where asset specificity is high, and where bounded rationality, opportunism, uncertainty, and frequency characterize the transacting environment, the fundamental transformation represents an increase in transaction costs. It should be noted that whether hierarchies (governance regimes) economize on relative costs, they are more costly than markets in terms of *absolute* costs. High asset specificity, then, implies high transaction costs, which implies hierarchy. Correspondingly, low asset specificity implies low transaction costs which implies market governance. Intermediate levels of asset specificity would then imply a hybrid form of transactional governance (Williamson, 1991a).

This paper contends that societal actors including institutions, policy makers, firms, and individuals, may *reverse* this transformation in two contexts: autonomous economizing, and coordinative economizing as more fully discussed below, by understanding and thereby influencing the level of asset specificity operating in a given situation.

Autonomous Economizing

Substitutions at the margin for which price serves as a sufficient statistic are considered to be autonomous adaptations (Williamson, 1991b). Generally these may be thought of as the boundary decisions which affect hierarchic v. market governance. The central objective of transaction cost economizing in the autonomous sense is to:

"... align transactions which differ in their attributes, with governance structures, which differ in their costs and competencies, in a discriminating (mainly transaction cost economizing) way" (Williamson, 1991b: 79).

Where transaction costs are the "costs of running the economic system" (Arrow, 1969: 48), they may be considered to be "the economic equivalent of friction in physical systems" (Williamson, 1985: 19). This friction is minimized by the autonomous adaptations effected by the operation of the price mechanism. As noted earlier, these friction/transaction costs hinge particularly upon the level of asset specificity related to a transaction. Where the instrumentality of command is an attribute of the economic structure (and it is assumed that this feature will continue to have influence during a continuing period of transition), two types of maladaptations can occur as a result of the impediments to the operation of the price mechanism which result. These policy errors prevent the efficient governance of transactions as illustrated in Figure 1:

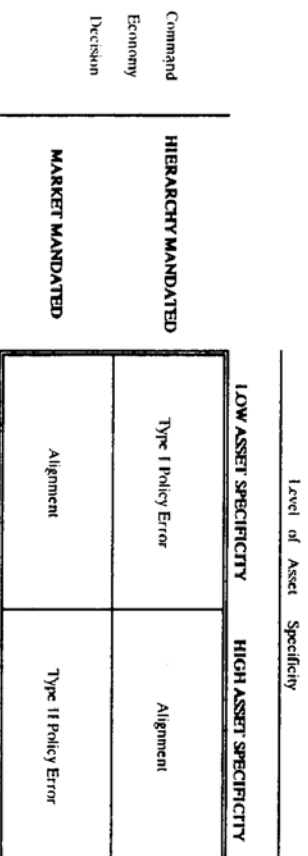


Figure 1

Maladaptations in Autonomous Economizing Due to Policy Errors

Thus, where low asset specificity as an attribute of transactions would imply market governance as a result of adaptive first order economizing, attempts to govern transactions within a hierarchy would constitute the Type I policy error illustrated in Figure 1. This appears primarily to be the type of error committed during the era of state sponsored socialism as manifest in the large centralized units of production, referred to herein as "macro-institutions". Conversely, where a high level of site or physical asset specificity would, under adaptive economizing, normally lead to hierarchy as the most efficient form of governance, attempts to govern transactions related to these assets via market mechanisms would also be predicted to fail. Should the headlong rush to move to market governance continue without attention to these first order economizing considerations, this Type II policy error may presently and in future be made by policy makers and other societal actors. Essentially, firms need not fail when the market forms. Accordingly, it appears likely that:

Proposition 1: To the extent that physical or site specificity exists as a consequence of the former command economic structure, transaction costs will be minimized where hierarchies are left intact.

A Property Rights Interpretation. Fundamental to the discussion of the effects of transaction cost economics is the issue of property rights. The preceding argument has been framed under the assumption that property rights in intermediate product markets are well-defined and easy to enforce. Admittedly, this is not presently the case in Eastern Europe or in the Republics of the former Soviet Union. Therefore, it seems useful to consider the application of the autonomous economizing model to circumstances where property rights are neither well defined nor supported by a societal tradition of credible commitment to their enforcement (Williamson 1991a, 1991b).

Under a weak property rights regime, the fundamental transformation is induced at a lower level of asset specificity since inducements exist for transactions to be integrated (forward, backward, laterally) to mitigate expropriation hazards (Tecece, 1986). Alternatively, where governance structures are not readily alterable to safeguard transacting (a Type I policy error), it should be expected that "farsighted agents ... recognize that their market development efforts will be expropriated ... unless they are able to develop ties ... which preclude the (expropriation) scenario from materializing" (Williamson, 1991b: 84). In essence, transacting agents must "take a hostage" thus raising the level of asset specificity such that a safeguard is mandated. It should be emphasized that the cost of such safeguards is an increase in transaction costs, i.e. the friction in running the economy goes up in this circumstance, thus contributing to dislocation, chaos, and other such drains on the societal well being. Such increased friction implies:

Proposition 2: To the extent that property rights are strengthened, the transaction costs in terms of dislocation and chaos will be attenuated.

(Co)ordinative Economizing

It has thus far been argued that at the center of the effort to minimize firm failures incident to market formation in the formerly command mediated economies, is the mitigation of policy errors in autonomous first order economizing, where "... consumers and producers respond independently to parametric price changes so as to maximize their utility and profits, respectively" (Williamson, 1991b: 77). However, substitutions at the margin for which price is not considered to be a sufficient statistic require adaptations of a coordinated kind (Williamson, 1991b: 77). Where dependencies exist among economic actors, e.g. within a hierarchy, coordination is necessary to facilitate effective first order economizing. Essentially this translates into coordinative efforts to eliminate internal waste and inefficiency.

Attention to the elimination of these coordinative transaction costs also appears to have been limited during the period of state sponsored socialism. As noted by one commentator,

"... the problem with Marx's work stems from his political beliefs and not his theoretical system ... His political sympathies led him to focus on the macro-structures (in the economy) and largely to ignore micro-structures" (Ritzer, 1979: 35).

In short, the dangers of socialism's "bureaucratization of economic life" (Lange, 1938: 109) were noted but not attended to. As a result, a set of first order costs due to waste of all types also operates in the hierarchy to market transition calculus.

Waste and asset specificity, specifically human asset specificity, are closely related. Asset specificity has traditionally been defined as *redeployability* (Williamson, 1985, 1991b). As previously noted, under the weak property rights regime presently operating in Eastern Europe and the former Soviet Republics, for economic agents to safeguard their transactions, economic inefficiencies (economic hostage taking activities) must be introduced, which increase the level of asset specificity, and correspondingly increase transaction costs. These include actions such as the creation and perpetuation of informational asymmetries, pervasive superior/subordinate bargaining, and the dysfunctional reliance upon politicking and contacts to "get things done" (Pearce, 1991).

Accepted, then, as a part of economic life for the past 70 years, has been a set of transactional practices which operate to increase the costs of running the economic system *within hierarchies*, which have no benefit, at least at the societal level, to justify their incurrence. Thus, when considering what might be done to facilitate movement from hierarchy to market while minimizing the failure of firms, it might also be argued that attention to first order economizing of a coordinative nature is also essential.

This contention envisions *reversals* of the fundamental transformation such that assets which are maladaptively internalized (wasted in firm employment) might be returned to market governance. Such an argument conceives of "tuning" or "adjustment" type activities on the part of economic agents which, through the elimination of waste both endows society with the benefit of underutilized assets redeployed, and also reduces the likelihood that the firm thus unburdened will fail. Hence:

Proposition 3: Where action is taken by societal actors to eliminate waste or inefficiency within firms, the move from hierarchy to market should be stimulated (through reversals of the fundamental transformation) while the prospect of firm failure is attenuated.

Asset Specificity, Alignment, and the Pace of Transition. It has earlier been argued that under a command economic system, the form of governance (the large macro-institution) was a consequence of the nature of the planning hierarchy. Under a transaction cost interpretation, the former command economic structure or planning hierarchy was, in many cases, substituted for the market in error. This occurred where asset specificity was low, but transactions were nevertheless subjected to hierarchical governance for political reasons: the "Type I policy error illustrated in Figure 1.

Proposition 1 advanced the notion that where asset specificity is presently high, for whatever reason, firm failure during transition from hierarchy to market may be attenuated through first order economizing on adaptive transaction costs. Proposition 3 put forward the idea that firm failure in transition may be also attenuated through first order economizing on coordinative transaction costs.

When the coordinative transaction cost savings consequent to reductions in waste and inefficiency are considered in tandem with the adaptive savings realizable from avoidance of Type II policy errors, it becomes possible to conceive of strategically managing the pace of transition. Consider, for a moment, how asset specificity and alignment operate. High asset specificity implies hierarchy, which economizes upon *relative* transaction costs. Similarly, high alignment implies a condition where hierarchical governance economizes on *absolute* transaction costs. Each in their own way impact the nature of economic substitutions at the margin, but in an inverse manner. That is, as asset specificity is reduced, the market is predicted to be relatively more efficient in transactional governance. Transactions are predicted to move from hierarchy to market, often involving firm failures. Conversely, as coordinative alignment is increased, the absolute efficiency of the firm is enhanced, thus reducing the likelihood of firm failures.

Hence, if one accepts that in the command economic context, the level of both asset specificity and alignment are responsive to strategic (policy level) influence, then it might be argued that societal actors might be capable of raising alignment while lowering asset specificity. Accordingly it is proposed that:

Proposition 4: The pace of transition from hierarchy to market, and thus the survival rate of firms, may be influenced by policy level strategic actions which simultaneously raise alignment while lowering asset specificity.

POSSIBLE APPLICATIONS

It has previously been argued that transaction cost theory provides a framework within which policy makers may strategically influence the nature of the transition from hierarchy to market. A discussion is now in order which dimensionalizes the theory in such a way that possible applications of this framework may be considered. Specifically, this paper argues that by acting upon or "tuning" elemental aspects of transaction sets (firms or portions of firms) which it appears desirable to move toward market governance, firms need not necessarily fail as the market forms.

Two notions, the strategic attenuation of asset specificity, and the enhancement of alignment, are crucial to the arguments advanced herein. In the case of the capitalist economic employment of transaction cost theory, asset specificity has most often been viewed as a "given". In the case, however, of the command economy in transition, this assumption does not necessarily hold. It is argued here that just as the increase in asset specificity was possible under the assumptions of central planning, so its attenuation is also possible as command economic mechanisms are applied to enact a "hierarchy to market" transition.

Strategic Attenuation of Asset Specificity

"The organization of economic activity is massively influenced by the degree to which the transactions under examination are supported by assets that are specific to the parties" (Williamson, 1985: 204). It is a fundamental proposition of transaction cost organization theory, that the underlying transactional attribute of asset specificity requires the discriminating matching of governance structures based upon that attribute (Williamson, 1985). To effect a change in governance structure, this paper posits that a change in asset specificity is required. If the characteristics of assets stated for decentralization can be strategically modified to be susceptible more to market and less to hierarchical governance, the transition toward market governance can be served. It is argued that only when specific features of asset specificity are understood at an explicit level of particularity, can strategic market actors exercise effective influence on the processes of transition. It is toward this end that a more detailed enumeration of these features is undertaken. Accordingly, three main areas where asset specificity attenuation appears to be possible are explored in greater detail: discreteness, contestability, and price mediation.

Discreteness. Within transaction cost economics, discreteness refers to the fungibility and immediacy of transactions. Where products are discrete (Macneil, 1978; Williamson, 1985), standardization is often the distinguishing characteristic, such that the identity of the

parties and the time required for contract execution becomes irrelevant to the efficacy of the transaction. For example, commodity contracts traded on the Chicago Mercantile Exchange are discrete. One contract of "March Corn" is exactly identical to another, the trading parties are operationally anonymous, and the time it takes for contract execution is virtually instantaneous. Hence, because of this discreteness, the contract of "March Corn" is tradable in a market.

To the extent that assets have qualities of discreteness, they are less transaction specific. Qualities of discreteness include standardization, anonymity, and immediacy (Williamson, 1985). In a sense, the term standardization appears to be almost synonymous with discreteness. "In an organized market the participants trade a standardized contract such that each unit of the contract is a perfect substitute for any other unit." (Tisler and Higinbotham, 1977: 997). Discreteness or standardization may be observed in a multiplicity of attributes of the transacting environment. These include but are not limited to attributes related to products, attributes in the employment relation, attributes of the legal system, and locational attributes.

With respect to products generally, standards may be established among quality, quantity and price, such that any customer, whether of intermediate or final goods, might easily distinguish and rely upon these essential characteristics of the product (i.e. reducing asset specificity by enhancing standardization (discreteness)). With respect to the employment relation, standards may be manifest in the command economy setting where individual responsibility systems replace the commune system (Chang and MacMillan, 1991). In the case of the command economy legal system, standard transactions may only be efficacious where property rights and contracts are a feature of the transacting environment (McLellan, 1991). Where standard contracting characterizes transactions, classical contract law enhances discreteness, and intensifies presentation (Williamson, 1985). Under this ordering regime, market transactions are efficacious: "Sharp in by clear agreement, sharp out by clear performance" (Macneil, 1974: 738). In the locational sense, discreteness-standardization would imply that industry would be free to develop according to the direction of the price mechanism as it mediates the supply/demand relation (Chang and MacMillan, 1991). Accordingly, the presence of asset discreteness may be expected where there is evidence of product, motivational, legal or locational discretion. (Note: A much more extensive explication of these particular concepts is possible and warranted, but has been excluded here for the sake of brevity.)

Thus, when it is argued that actions on the part of strategic actors to enhance discreteness will effect transition, it is intended that such actions would translate into effecting some or all of the above noted circumstances of the transacting environment. Admittedly, strategic influence on all attributes of discreteness at once may not be possible in a given instance, but the contention remains that as (for example) standards of quality, motivation/incentive, contracting, and/or property rights are enhanced, transition to organizational forms more congenial to operation in a market system (i.e. a movement from hierarchy to market) are predicted.

Contestability. The concept of contestability refers to the element of competition within a market. A necessary condition for contestability is the absence of limitation on the number of potential economic actors. Entry and exit are not constrained by market imperfections such as barriers to entry, too few competitors, isolating mechanisms (Rumelt, 1987), etc. Rather, competitors enter the economic arena the moment advantage is evident. Examples in the U.S. economy include grocery stores, banks, motels, apparel firms, etc. (Thompson, 1989).

By definition, asset specificity implies low substitutability i.e. very few, if any, alternative means of obtaining a given product or service provided by specific assets. Asset specificity applies to site, physical, human, or dedicated asset non-substitutability (Williamson, 1985). Hence, to the extent that access to the means of production in the case of supply, or the means of distribution in the case of access to markets as represented by these four factors is unhindered, a higher degree of market success would be predicted. The presence of contestability or entrant multiplicity may be predicted, for example, where the lack of barriers to entry as represented by regulations, licensing, entry fee requirements etc. is observed. It is within this domain that strategic action by policy makers may be especially efficacious.

Price Mediation. Price acts as the communication mechanism in a fully contestable market. That is, the price of a good or service gives notice to would-be competitors that an advantage is possible. So, for example, in a competitive situation within the capitalist system, such as is the case in the motel industry (Thompson, 1989): when the price per room night reaches a certain point relative to the net variable costs of operation, debt service on construction, and occupancy percentage, competitors are attracted into the market. This communication-attraction function is termed price mediation.

According to Coase (1937), "the main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism. The most obvious cost of 'organising' production through the price mechanism is that of discovering what the relevant prices are" (Coase, 1937: 391) (i.e. the cost of information). It follows, then that the existence of any device which enhances general access to prices (i.e. to information) would increase the general probability of large numbers bargaining, thus attenuating asset specificity and promoting movement toward the market. Consequently, price mediation might be expected to the extent that the ready access to relevant pricing information is possible. Therefore, strategic action to build an information access infrastructure is argued to reduce asset specificity, and thereby facilitate movement toward a market system.

This paper asserts that movement toward market governance becomes possible to the extent that the characteristics noted above are present: they become *conditions precedent* to market governance. However, where they are absent, certain hazards develop which require alternate governance. The absence of these characteristics is of interest in the present context, because it is in these situations that the market "fails", that is, there is incentive to govern the transaction via a hierarchy. When applying this same principle to an existing

hierarchy, as in the present discussion of command economy, the problem then becomes the following:

Before a set of transactions (centralized organization) is moved toward the market, can we determine which of these "conditions precedent" is missing? And if so, can these elements be strategically stimulated such that centralized hierarchical governance becomes dis-economic at the margin with the result that the decentralization obtains?

It is argued that as this problem is solved, crucial elements of a market system which are necessary for its function will result. Having conceptually delineated this proposed causal linkage, a certain order in the transition from hierarchy to market may then be predicted: a type of transition governance. Using the notion of governance transition through asset specificity modification, it then becomes possible to specify the nature of policies which are likely to lead from hierarchy to market. In general, policies which operate to attenuate asset specificity are predicted to be positively related to successful transition (for specified sets of transactions) from hierarchy to market. Where such actions are not feasible, attempts to economize on coordinative transaction costs through the enhancement of internal alignment, while retaining the hierarchy should be encouraged.

The Enhancement of Alignment

The enhancement of internal alignment is much more straightforward conceptually, but, because of the nature of the incentive failures incident to Type I policy errors, highly intractable. This intractability has led many to conclude that there may be little alternative to firm failure in transition from hierarchy to market.

It would appear, however, that this conclusion is based upon the assumption that only the rigors of the market will serve as a sufficient disciplinary force to eliminate the waste and inefficiency endemic to maladaptive coordinative alignment. But this assumption is itself rooted in the credo of central planning (i.e. man is an agent to be controlled by economic forces v. a force to control economic agencies).

By virtue of a sound theoretical approach to coordinative economizing, it appears possible to suggest that where economic actors can be shown that first order economizing redounds to their direct benefit at multiples as great as 10:1 in comparison with second-order (price-based) economizing (Williamson, 1991b), enhancement of alignment may, in fact, be practical. At once, this demands a policy level dialogue, a galvanizing of national will: in short -- societal leadership. Because of the momentum of changes now underway, and the momentum which accompanies the desire of economic actors to move toward the market economy model, it does not appear unreasonable to suggest that such leadership is possible.

POTENTIAL BENEFITS

The application of transaction cost economics in the public policy setting undertaken in this paper suggests at least three benefits to society and its actors. These include: (1) the attenuation of chaos, (2) the establishment of fundamental soundness in hierarchy to market transition, and most importantly, (3) the potential for better preparation of both physical and human assets for market governance.

Attenuation of Chaos

By definition, chaos and organization are juxtaposed: organization implying order, and chaos implying disorder. Transaction cost economics as a theory of "organization", seeks to define ordering processes in terms of a rational but open system (Scott, 1987a). In such a system, prolonged chaos is damaging, since the friction in the system (Arrow, 1969) represented by transaction costs remains high. Thus, lower first order costs imply welfare economic benefits to society (Williamson, 1991b), since where transaction costs may be reduced through first order economizing, the disorder manifest in high transaction cost settings may also be expected to abate. In short, first order economy is the best policy, where attenuation of chaos is desired.

Soundness in Transition From Hierarchy to Market

In the republics of the former Soviet Union and its former Eastern European satellites, the present rapid transition away from a command economy, and toward the market is a societal mandate. This mandate, however, stems not from the edicts of a central authority, but from the notion that "the fate of democracy in Russia (and this may be presumed to apply to other CIS Republics and to Eastern Europe as well) will be determined to a great extent on the economic front" (Kozzyrev, 1992: 8). In the process, the wealth of nations which has heretofore been held collectively must, as equitably as possible, be made accessible to ordinary economic actors (Wanniski, 1992).

Where this transition ignores the principles of first order economizing articulated by transaction cost economics, its soundness is predicted to be in doubt. In adaptive economic situations, firm formation and failure will to a large extent be determined by levels of asset specificity, and by the strength or weakness of the extant property rights regime as an intervening variable. Where the elements of discreteness, contestability and price mediation previously discussed are features of the transacting environment, the market is predicted to govern more efficiently. To the extent that strategic action is possible to enhance these features, thus lowering asset specificity, soundness in transition may be predicted. But to the extent that high site or human asset specificity when combined with the weak property rights system presently operating continues to predominate within the transacting environment, the retention of hierarchy as a governance mechanism (avoiding the Type II policy error) is recommended.

In coordinative economic situations, the soundness of transition from hierarchy to market as evidenced by firm formation and failure will be determined to a great extent by the level of transaction costs *within* existing hierarchies. Once again the level of asset specificity, this time *internal* asset specificity, is argued to determine the level of first order economizing. Where internal risks are high e.g. procedures are incommensurable v. standardized, pervasive superior/subordinate bargaining characterizes internal transactions, etc., internal waste (first order inefficiency) is predicted to compromise the survival of hierarchies, and firms *will* fail when the market forms -- but needlessly so. The fundamental soundness of hierarchy to market transition, and by extension the "fate of democratic reforms" (Kozmyrev, 1992: 8), both rest at least to some extent, upon a foundation of internal first order economizing.

Better Preparation of Physical and Human Assets for Market Governance

The notion of *preparing* physical and human assets for market governance rests on the premise that asset specificity is *not necessarily* a "given", i.e. it may be affected by actions at the strategic/policy level. Asset specificity has traditionally been defined as *redeployability* (Williamson, 1985). Thus, in the case of the command economy, 70 years of physical asset and site decisions have made asset specificity a relative constant. Big industry is constituted in a highly concentrated geographical and hierarchical manner. Where this is the case, preparation of physical assets for market governance requires careful consideration to avoid the Type II policy error discussed previously.

However, the type of asset specificity which appears to be most susceptible to "preparation" is that of human asset specificity. Asset specificity is high where durable investments are made in support of particular transactions, the value of which investments is plainly lower under alternative employment; where the identity of the parties to a transaction plainly matters; and where contractual and organizational safeguards arise in support of the transaction (Williamson, 1985: 55). In the case of human asset-based transactions which arise as former command economies attempt transition to the market, asset specificity arises as a consequence of informational asymmetries (impacted knowledge), specialized skills, and the continuing necessity to transact on the basis of politics, contacts, and "command and administer" processes (Kozmyrev, 1992: 6), which persist even after the demise of the command economic structure of the former Soviet Union.

To the extent that the society continues to support these elements of asset specificity, potential first order economizing gains are compromised. But to the extent that a systematic approach to reducing human asset specificity is possible, a successful transition from hierarchy to market may be encouraged. What must be done? The answer lies in strategic action at three levels of society: (1) the societal assumptions level; (2) the institutional level; and (3) the firm level.

Societal Assumptions. Where a national dialogue can influence the societal assumptions upon which the level of human asset specificity rests, a policy intervention to

attenuate human asset specificity appears to be possible. The term "societal assumptions" refers to ingrained values which specifically affect the level of adaptive *and* coordinative economizing. These include (among others) attitudes toward corruption, shirking and hoarding. This paper argues that it is the job of the leadership within a society to provide an articulation of values which will mitigate the destructive impact of continuing high transaction costs. "Marx omitted from his economic model" the notion of transaction costs which are ultimately determined "by the degree of risk involved in economic activity" (Wanniski, 1992: 21). Until the cost of these risk creating attitudes is energetically and clearly articulated, the first order economizing benefits available in transition are predicted to remain elusive.

The Role of Institutions. Institutions in society are "a natural product of social needs and pressures" (Selznick, 1957: 5). Organizations develop distinctive characters and structure through the process of *institutionalization* (Scott, 1987). "Institutionalization involves three phases: externalization, where a group takes action; objectivation, where this group plus others interpret those actions as having an external reality separate from that group; and internalization, where the subjective structure of the objectified world is internalized (Scott, 1987b). Thus, at the institutional level, the social needs of an economy in transition must first be articulated or externalized. Such articulations as objectivations can then be internalized by the various organizations within society as a completion of the institutionalizing cycle.

What articulations will impact the efficacy of first order economizing? Based upon the theory developed in this paper, it is argued that institutions which support or enact strong property rights, standards of quality (such as ISO 9001, the international product quality standard), and an audit/verification tradition would substantially contribute toward lower first order transaction costs in governance transition, due to the reduced level of human asset specificity which is predicted to result.

Reducing Human Asset Specificity at the Firm Level. Human asset specificity within a hierarchy properly falls within the domain of agency theory (Jensen and Meckling, 1976a). Where human asset specificity is permitted to remain high, i.e. individual employees can *hold an economic hostage* due to their specific skills, information impactiveness, connections, etc., first order transaction cost economizing is predicted to suffer. Firm failure as the market forms is the predicted consequence, since the burden of waste due to transaction cost diseconomies will tend to force hierarchies toward disaggregation.

Where the level of human asset specificity within a given hierarchy can be managed through such mechanisms as centralized personnel functions in combination with enterprise unions (Williamson, 1991b), coordinative efficiency is predicted to result.

Concluding Remarks

Based upon more realistic behavioral assumptions than those of the neoclassical economic model, transaction cost economic theory attempts to illuminate and explain organizational structure/governance (Williamson, 1985). First order economics (saving on transaction costs) have the potential to exceed second order economics (price equilibration of supply and demand) by magnitudes of as much as 10:1 (Williamson, 1991b). This paper argues that these first order economic benefits are available through strategic action at the public policy level -- that transaction cost economics provides an "external standard with respect to which a switch of vision (may) be demonstrated", and alternative perceptual possibilities may be drawn (Kuhn, 1970: 114).

Specifically, this paper has argued that where public policy initiatives in the transition from hierarchy to market are taken with the level of asset specificity in mind, first order economizing benefits become available which mitigate certain less desirable effects of that transition. The thesis of this paper, that firms need not fail when the market forms, although somewhat preliminary in its development, derives from this premise. The propositions advanced herein are intended to stimulate comment and future thought on the application of transaction cost economics to a mitigation of the societal impacts of governance transition in the macro institutional setting. Hopefully this contribution toward a beginning point, will be supportive of this purpose.

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