

Institutional Economics at the Micro Level? What Transaction Costs Theory Could Learn from Original Institutionalism (In the Spirit of Building Bridges)

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Inertia in the academic environment sometimes obstructs the incorporation and development of some ideas. That is what is claimed in the case of the long gap separating Ronald Coase's seminal paper [1937] that laid the foundations of current transaction costs theory (TCT) and the efforts of scholars to develop his ideas [Azevedo 1996, 5]. But as TCT has evolved and become associated with the name of Oliver Williamson, it has become clear that its development has also been impeded because it has absorbed Williamson's tension "between an intuitive commitment to realism . . . and his commitment to some core presumptions of mainstream economics" [Hodgson 1998a, 189ff.]. Most TCT scholars seem to hold fast to the latter commitment, and this could mean losing a chance to enrich economics methodologically and theoretically. Attempting to avoid this, our paper regroups and comments on criticisms by "original" institutional economists (OIE) of TCT. We do this in the spirit of building bridges by discussing (1) discrepancies between TCT's and Commons's concepts of transaction; (2) TCT's use of efficiency as a *status quo* rationalization; (3) the static analysis that ignores institutional feedbacks; (4) the assumption of opportunism; and (5) the incompatibility of bounded rationality and optimizing behavior.

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Misleading Inheritance? Transactions in Williamson and Commons

The first criticism is of the use of transactions by TCT as a unit of analysis—an idea attributed by Williamson [1996, 371] to John R. Commons. This inheritance is, however, contested. Commons's concept of transaction involves property transfers with all their underlying incorporated rights, and this differs from exchange, which refers to physical transfers. Williamson sees the transaction as the passage with frictions between separable production interfaces. The difference is illustrated by Yngve Ramstad [1994, 330], who notes the lack of similarity among the concepts, since most transfers of goods in capitalism do not involve passages through different technological interfaces, but "merely" through different agents without changing the underlying objects. They are transfers of property rights whose features are defined outside the exchange itself. Commons identified three types of transactions [McClintock 1987, 674-5]:

1. Bargaining transactions, involving voluntary transfers of property rights over scarce goods among legally equal agents.
2. Managerial transactions, characterizing labor relationships, involving the promotion of technological efficiency and creation of wealth in productive processes.
3. Rationing transactions, involving decisions of legal superiors on burdens and benefits of legal subordinates in social reproduction; it is accomplished with the exercise of sovereignty.

Regarding collective arrangements developed in a society or group of individuals and of sovereignty spectrum thereof configured, transactions may be classified in those three categories. Markets—as institutions created by collective actions—work in agreement with the principles of property rights, resolution of conflicts, and performance requirements delineated by the exercise of sovereignty.

Although Commons [1950, 56] divided transactions for analytical purposes, the levels are linked in daily social relationships, requiring an analysis of economic systems within the social context as a whole. This can be seen in the case of rationing transactions designed during a meeting of a firm's directors without bargaining with subordinates. The execution of tasks results from managerial transactions, while bargaining transactions depend on previous settlements by legal superiors of rationing transactions. Once wealth is created, payoffs of bargaining transactions to individuals derive from the power related to each position in the arrangements of rationing and managerial transactions—thus, among economically unequal, although legally equal, individuals.¹

Thus, Williamson's view could be considered part of Commons's, since the former seems to reduce all cases to bargaining transactions.² For Commons [1950, 53], such transactions can occur in the form of performance-payment, as prevails in

markets,³ but also over short- or long-terms and can embrace, at least in time and subject of contractual obligations, Williamson's designed spectrum of transactions. But when claiming the transaction as a unit of economic analysis, Commons had set it in the inseparable interaction among those *three* distinct levels.⁴

Efficiency, Power, Competition, and Selective Process

OIE also criticizes the lack of concern with power in TCT.⁵ According to Edythe Miller [1993, 1044], TCT helps orthodoxy to justify power concentration. Williamson [1995, 32] admits some relevance of power in transactions, but he asserts it is a vague concept that is generally used in *ex post* rationalizations and impossible to define in crucial analytical dimensions. Miller, however, sees this as an accommodation, for it removes the influence of power as an analytical tool in economics, thereby implicitly justifying power concentration as consistent with transaction costs' minimizing criterion. In TCT, efficiency overrides equity, distribution, and use—and abuse—of private power [Miller 1993, 1049].

On the hierarchical feature of power, Geoffrey Hodgson [1993, 90] says: "By trust or compulsion, that is by the use of social power, the managers of the firm may succeed in imposing their will on the employees. Without this ability to generate more cohesive and less atomistic behaviour the firm would not be able to function." The concept of *fiat*, used by Williamson to criticize the "nexus of contracts" stream and reinforce his claim on the relevance of authority, however, seems yet to leave him within the neoclassical sphere of free individual choices in any situation as long as he ignores power.⁶

For TCT, internal labor markets seek reductions in *ex ante* and *ex post* transaction costs in labor contracts. While this may lead to adaptations that promote allocative or transactional efficiency, it can also lead to an efficient compensation for the employee to ensure appropriate incentives [Jacoby 1990, 328]. If such conditions are not satisfied, an efficient contract does not obtain, and we may face the unilateral exercise of power. That can happen when employers neglect revision of incentives, thus accelerating or slowing processes of institutional change whose results rarely are efficiency. For William Dugger [1996b], the expansion of great corporations builds governance structures that resemble what he calls "corporate-states." Competition, cooperation, and cheating are common among corporate-states (and among corporate-states and nation-states) in their race for positions, turning efficiency into a secondary issue when analyzing modern corporations.⁷

Janet Knoedler [1995] contrasts the TCT concept to Veblen's view of transactions. For her, Veblen does not reduce the targets of transactions to the coordination of production with efficiency criteria, although this is not entirely unimportant.⁸ Firms seek not only gains through larger efficiency, but they also seek pecuniary gains that may or may not involve lower production/transaction costs. Within a

competitive atmosphere, firms will act strategically, struggling for pecuniary gains to conquer and sustain positions. Whenever possible or needed, they will try to put rivals in "insolvent or unhealthy" situations or even to sabotage industrial efficiency.

Moreover, competition involves more disputes than apparent in relationships among agents and principals and in make-or-buy decisions, since few transactions are immediately fulfilled: "Most transactions involve a first mover and a second mover. The second mover acquires an advantage over the first mover and can impose costs on the first mover, particularly if we assume self interest with guile and bounded rationality" [Dugger 1993, 197]. The benefits for "second movers" are then ubiquitous: they exist with prior payment for goods or services, in employment transactions in which wages are earned or work conditions and terms are only known after an employee has worked for some time, and in financial transactions involving corporate funds over which property and control are separated [details in Dugger 1993, 198]. So ubiquitous are multiple transaction costs—even in simple market transactions—that this has been seriously underestimated in TCT studies.

For Williamson [1985, 236], power can lead to vertical integration, but he insists that it will not last without efficiency. Miller [1993, 1048] remarks that this means the acceptance of a process of natural selection that makes existence and efficiency equivalent, contrasting to Williamson's [1985, 23] doubt on a plausible form of selection to use in TCT.¹⁰ If power is included instead, "artificial" Darwinian selection or Lamarckian analogies would be more appropriate, as less efficient agents could use their power (e.g., acquired by employing many people in a small site) to change the environment or the rules of the system [Ramstad 1996, 420].¹¹

Institutionalism without Institutional Feedback

Economic orthodoxy has never excluded all institutional features of economic systems, but has focused almost exclusively on one of their parts: the market [Miller 1993, 1050]. What TCT has done is to add another part—the firm.¹² Severe limitations remain, however: efficiency remains a legitimate end above human wills and guides all economic actions.¹³ Although TCT considers collective actions (firms vertically integrating or the opposite), there is only one causality direction—from individual actions and bilateral exchanges to economic structure.¹⁴ No reference is made to the reverse flow and therefore to social processes, which are dynamic by definition [Pratten 1997, 792].

Williamson [1996] recognizes the need to analyze the influence of environmental change on individual agents, but he then exempts himself from the task, insisting on the individual's primordial pulse for designing institutional mechanisms.¹⁵ Hodgson [1988, 206] relates this to Williamson's essentially neoclassical position that "in the beginning there were markets," as if they were the natural, ubiquitous, and timeless

state of the world, independent of more basic institutions. Thus, TCT ignores social evolution with its process of cumulative causation that ties institutions in dependent paths emerging from crucial decisions. Dugger [1993, 211] exemplifies: in a firm drawn on the faith of opportunism, individuals learning about their environment and adapting to it can absorb the precept and incorporate it to their culture, thus learning how to be more opportunistic. Firms react, deepening the structural components related to that expected precept of individuals, creating a cumulative circle.

Work performance, then, is not derived from an unchangeable human nature paved by opportunism. Human behavior can be built from social institutions within which agents interact. Thus, we should see the firm as an institution able to mold preferences and human actions and to perhaps increase levels of cooperation, trust, and loyalty among agents [Hodgson 1988, 211; 1998a, 191; Simon 1991, 31-7].

Opportunism: Simplism and Inconsistencies

The problems with Williamson's view of competition can be found in his concept of opportunism, as he "assumes that some people will lie and cheat . . . but he does not assume that they will coerce and kill (as some real people do)" [Dugger 1996b, 1214].¹⁶ To Maria Moschandreas [1997], the assumption of opportunism is insufficient to identify human behavior and its interactions and leads to internal inconsistencies in TCT. First, Moschandreas suggests that TCT understates the role of culture in behavioral determinants. If individuals have varied behavioral motivations, one cannot consider only the extent of opportunism, disdaining the rest, e.g., trust or honesty, that can bring positive effects that overcome opportunism. Moschandreas [1997, 42] delineates a possible negative feedback from such reduction: "Systems [that] incorporate auditing, monitoring, and the adoption of administrative lines of authority and subordination . . . may have serious adverse effects on the work 'atmosphere', encouraging perfunctory, rather than cooperative, behavior."

Moschandreas also remarks that the alleged ubiquity of opportunism is not consistently followed within TCT. Asymmetries between agents arise in "the implicit assumption that top officers will not behave opportunistically toward their subordinates although the same officers may or may not be expected to behave opportunistically toward their shareholders. . . . [And in] the explicit . . . assumption that top officers running large M-forms will strive to profit maximize" [1997, 49].¹⁷ Moreover, for the suspicion of opportunism to arise, information flows should be free and efficient—a hard condition to obtain. In some cases, bad conduct can take some time to appear, and information and measuring costs can imply that it will never happen. Concerns about reputation can only soften opportunism, and as long as it persists, so does inefficiency. It is worth reminding that Williamson [1985, 44] is allegedly concerned with studying human nature as it really is.¹⁸ But his reference

only to opportunism contradicts that [Hodgson 1996, 250].¹⁹ For example, Williamson argues that M-form firms' managers are more exposed to the market of corporate control when working inefficiently, which restrains opportunism. However, information asymmetry in the market of corporate control imposes costs to searching for potential targets. "Conglomerate management can monitor the management of subsidiary corporations, but who can monitor conglomerate management?" [Dugger 1993, 201]. So takeovers do not eliminate managerial opportunism, as Williamson [1975, 40] suggests, but just move it a step above.

Bounded Rationality and Optimization: Incompatibility

The "contractual man" has a further shortcoming: rationally bounded agents are not compatible with static-comparative optimizing analysis, which demands estimating costs of each governance structure [Hodgson 1993]. Bounded rationality fits with *satisficing* behavior, given the restricted capacity of agents to process information and foresee events [Simon 1957]. Such limitation, independent of the availability of all relevant information, shows the impossibility of accomplishing exact calculations for comparative analysis. Moreover, decisions on organizational forms are *ex ante* by definition, and the heuristics or feasible calculations depend on expectations about the uncertain future.²⁰ When choosing the "best" organizational form, agents need to build confidence intervals of the joint costs of each considered governance structure²¹ for selecting the "cheaper" one. But is it possible to calculate such intervals? Would they be identical if done by different agents, each with their own bounded rationality and thus with discretion over existing information? If two intervals are seen as coherent, how does one decide if they intersect?²²

"Minimizing" seems to be a different expression for optimizing behavior, although Williamson is apparently concerned *not* to elucidate the point [Hodgson 1993, 95].²³ Williamson [1993, quoted by Pratten 1997, 794] says that "satisficing is cumbersome and we must ask whether the added cost (of non-standard and more complicated modes of analysis) justify the benefit (realism of cognitive assumptions). . . . the answer would appear to be negative." But the internal tension emerges as he affirmed before that "[TCT] relies on economizing arguments (which disciplines the analysis and appeals to maximizers) but substitutes comparative institutional for optimizing procedures (which is more in the spirit of satisficing)" [Williamson 1993, quoted in Pratten 1997, 794].²⁴ It seems that the weight of optimizing behavior is increasing in TCT.

Final Remarks

Williamson [1996, 240] says that history matters, but TCT scholars generally understate the role of the history of economic thought, particularly of OIE [Hodgson 1998b, 166]. During and after the consolidation of the liberal agenda and the assumption of the primacy of markets (the result of joining neoclassical theory and the Austro-libertarian tradition), OIE was disregarded by the renewed economic mainstream [Chang 1997, 2]. OIE nonetheless is alive (and kicking), with plenty of subjects to discuss with the so-called "Transaction Costs, Markets and Hierarchies" research program [Pitelis 1993]. Accordingly, we have approached the concepts of transactions for Commons and Williamson. Although we can optimistically consider that bargaining and managerial transactions are included in TCT, the rationing one is not. Actually, the latter depends on environmental determinants (e.g., legal systems or "private" institutions acting in regard of private property rights) and is ignored by Williamson. But if capitalism is the environment, we cannot ignore the higher levels of discretion over decisions about allocation and rewards.

On the one hand, these problems come from the reticence of TCT analysts to consider power, which is submerged by efficiency as the only criterion of selection and as *deus-ex-machina* in decisions processes. On market power, OIE exhaustively recalls that firms act strategically, sometimes to promote efficiency, but often to disturb it. Yet, hierarchical power can lead to efficient results—not optimal ones, but efficient ones as firms' objectives are imposed on workers. The hierarchical power of great corporations gives them sovereignty to define survival conditions of employees. On the other hand, problems come from the lack of institutional feedback for individual agents. Human wishes and behavior have been molded or changed through time by institutions, and vice-versa. Omitting that means ignoring the very core of institutional change.²⁵ Opportunism, for instance, can be relevant for transactions, but human behavior cannot be reduced to it. Humans can be stimulated and learn to act differently and in ways that are not reducible to the cost-benefit calculus of breaking the law.

The coexistence of bounded rationality (and therefore, satisficing behavior) and optimizing procedures is also problematic. But to admit that would mean a large rupture with the neoclassical hard core, which would change TCT's framework and imply survival of non-optimal organizational forms, mimetic behaviors, and divergences on decision processes coming not from opportunism, but from cognitive diversity.

These problems notwithstanding, we believe that Williamson has developed an intellectual project that, besides exposing some limits of the mainstream, has its own merits. If he ignores power when looking at the size of firms, he shows that other factors (e.g., asset specificity) tailor the make-or-buy decision; if he overemphasizes opportunism, he also reminds us that organizations need to diminish the risks of non-cooperative internal conduct. For these and other reasons, we believe that OIE

should continue building bridges with TCT that go beyond engaging in civilized conversations guided by *Sprachethik* that should characterize (although normally it does not) intellectual exchanges in economics.

Notes

1. It is a form of collective action in which individuals engage in capitalist societies that becomes a hierarchy of collective actions controlling all three kinds of transactions (and the very individual actions).
2. Rutherford [1996, 127] considers Williamson's distinction between markets and hierarchies to be promising as it could mean the substitution of bargaining for managerial transactions. The use of *fiat* by firms represents the exercise of command for producing wealth, which is somewhat close to Commons's managerial transactions.
3. Williamson [1985, 32] follows MacNeil in defining this kind of transaction as having a contract that is "sharp in by clear agreement; sharp out by clear performance."
4. The individual "is confronted by sovereignty which does the creating and transferring of ownerships. Sovereignty imposes the duties of avoidance and forbearance which create ownership, and the duties of performance and payment which transfer ownerships. . . . He is confronted by the bargaining power of others compared with his own bargaining power" [Commons 1950, 52].
5. Power is defined by Klein [1987, 1341] as "the ability to influence decisionmaking"; in similar spirit, Bowles and Gintis [1990, 175] formulate: "For A to have power over B, it is sufficient that, by imposing or threatening to impose sanctions over B, A is capable of affecting B's actions in ways that further A's interests, while B lacks this capacity with respect to A."
6. Ménard [1996, 155-7] attempts to distinguish hierarchy from authority with no reference to power features. His distinction, however, does not create any category different from what non-mainstream critics of TCT would still call power, and he seems just to refute arguments from the "nexus of contracts" stream. Although it seems to be Ménard's only intention, it may show TCT's indifference to making power analytically "workable."
7. Dugger [1996a, 431-2] tries to catch Williamson's "motivations": "Both Commons and Williamson worked for the outsider. However, the outsider Commons worked for was virtually powerless (the labor movement) while the outsider Williamson works for is far from powerless (the giant conglomerate). With his 'clients' having little, Commons dealt explicitly with power in his formulations; with his 'clients' having much, Williamson does not." TCT, thus, "is relevant not for helping us to understand the inherent efficiency of corporate hierarchy, but for helping us to understand the growing power of corporate government" [Dugger 1996b, 1216].
8. "In Veblen's view, business persons may seek not only to coordinate production, but at times to disturb it" [Knoedler 1995, 388; see also Rutherford 1996, 107].
9. The ubiquity of transaction costs determinants is a debatable matter, as argued by Noor-dhaven [1996], Dietrich [1994], and Moschandreas [1997] for opportunism and Foss [1996] for bounded rationality.
10. Hodgson [1993, 94] says: "While both Williamson and the 'old' institutionalists appeal, to different degrees, to an evolutionary metaphor in their work, it does not support the kind of Panglossian interpretation to be found in the work of Williamson and many others."
11. Interdependence of agents, power, and strategic behavior not reducible to optimization are disregarded: "Structure of firms may have to do with the requirements of technology, or with certain power relations and conflicts within the firm, or with establishing the position of market control . . . exactly the issues raised in the OIE" [Rutherford 1996, 124]. Sa-

muels [1995, 580] also said: "Institutionalists reject concepts of the natural order of things in favor of a view of the world as created by human individual and collective activity and consequently as subject to human control rather than under the sway of automatic mechanisms."

12. Pitelis [1993, 7] describes Coase's 1937 article as transforming orthodox economic theory "from a mono-institutional theory to a duo-institutional, at first, and gradually to a poly-institutional one."
13. "To paraphrase Marx, efficiency acts as the motor of history" [Marginson 1993, 137].
14. Criticism of the methodological individualism used by TCT is widespread, although with some amenity, e.g., when considered the influence of firms' "organizational atmosphere" on individuals [Williamson 1975]; however, it seems that Williamson has abandoned the issue in his following books [1985, 1996].
15. "Feedbacks aside (which are underdeveloped in the transaction cost economics set-up), the institutional environment is treated as the locus of shift parameters, changes in which shift the comparative costs of governance, and the individual is where the behavioral assumptions originate" [Williamson 1996, 223].
16. See also the hostage model, which suggests the exchange of warranties when transactions involve specific assets. Credibility problems can lead to much harder attitudes as "coercion, kidnapping, arson, extortion, and contract murders, as well as mafia-like governance structures" [Dugger 1996b, 1214].
17. TCT explains such behavior by its adverse effects on reputation, but why could it not be extended for other employees? Marginson [1993, 138] says that, in TCT, "workers are assumed to act opportunistically, while employers are assumed to act in accordance with an (undefined) community interest." See also Dow [1987].
18. Coase's [1984, quoted by Williamson 1985, 44] original phrase is "Modern institutional economics should study man as he is, acting within the constraints imposed by real institutions."
19. "Failures of cooperation and coordination can also arise because of divergent perceptions, lack of information and understanding, or even incongruous individual motives which are entirely altruistic" [Hodgson 1996, 255].
20. It implies the need to explain how expectations are formed, and advances on the study of heuristics suggest that they cannot be seen as a kind of optimizing behavior [see Schwartz 1998, 139]. Anyway, Selznick [1996, 274] sees as positive the adoption of bounded rationality and uncertainty by TCT. See also Jacoby [1990] and Samuels [1995] for signs of sympathy from "old" to "new" institutional economics.
21. Due to agents' bounded rationality [Williamson 1985, 93, 96 ff.].
22. Or, as stated by Groenewegen and Vromen [1996, 370]: "If boundedly rational agents cannot be engaged in complete contracting for the reason that they cannot foresee future contingencies, then how can they foresee what governance structures will turn out to be most efficient?"
23. "The term 'satisficing' is employed by Simon precisely to distance his conception from 'substantive' rationality and maximizing behaviour. It is symptomatic that Williamson . . . uses the term 'bounded rationality' much more often than 'satisficing'" [Hodgson 1993, 95]. And further: "Whilst Williamson's contribution to postwar economic theory is of significant net value, it is marred by a terminological and analytical imprecision and the use of confusing and sometimes obscurantist jargon" [Hodgson 1988, 299].
24. Williamson had also affirmed: "Studying man as he is necessarily requires that behavioral assumptions be assessed not merely with reference to analytical convenience—which is a leading reason why maximizing assumptions play such a prominent role in economics—but also with respect to their correspondence to reality. Implausible behavioral assumptions are not a matter of indifference, much less merit, if studying human nature as we know it is to be taken seriously" [Williamson 1987, quoted in Pratten 1997, 799].

25. As when putting aside the effects of different firms' "atmospheres" on the direction of transformations.

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