Does organization matter to an understanding of the modern corporation and to the design of public policy that affects it? The answer to that question has changed considerably during the past 40 years. Although if the microeconomics textbooks used in most MBA courses are to be believed, the answer—both in 1955 and 1995—is that the organization does not matter very much.

**Successive Developments**

A unifying theme—but not a unified theory—runs throughout the MBA curriculum: How does the well-run business firm function? All of the core courses—marketing, production, organizational behavior, finance, accounting, economics—address this question. Of these, the discipline of economics is the most general and arguably speaks with the greatest academic authority.

The basic theory of the firm that is featured in microeconomics textbooks describes the firm in technological terms as a "production function" in which inputs (labor, capital) are transformed into outputs (goods, services) according to the laws of technology. Upon assigning an objective function to the firm (usually profit maximization) and describing the market in which it operates, students learn how firms set price and output and respond to changing opportunities (demand, input prices).
This is important material and some of the associated ideas—marginal analysis, opportunity costs, tradeoffs—have truly wide application. Every MBA who understands these concepts and can apply them to the business environment has a big advantage. But does this theory, or more generally this approach, help us to understand the size, shape, and purposes served by the modern corporation and other forms of complex economic organization?

If firms are mainly technological entities, then their natural boundaries will be determined principally by technological economies of scale and scope. But firms that extend their boundaries beyond these natural limits then pose a puzzle. What explains these boundary-extension efforts?

Economists looked in their tool box and pulled out what appeared to be a general purpose explanation: monopoly was responsible for horizontal, vertical, and conglomerate structures and, more broadly, for nonstandard and unfamiliar contracting practices. Public policy toward antitrust was significantly influenced by this monopoly predilection. What came to be known as the “inhospitality tradition” took shape. Donald Turner captured the spirit of the 1960s (during his term as the head of the Antitrust Division of the U.S. Department of Justice) in his remark: “I approach customer and territorial restrictions not hospitably in the common law tradition, but inhospitably in the tradition of antitrust.”¹

Albeit widely shared, not everyone was persuaded. The 1991 Nobel Prize Winner in Economics, Ronald Coase, was among the first to take vigorous exception with these monopoly predilections. As he expressed it in 1972:

One important result of this preoccupation with the monopoly problem is that if an economist finds something—a business practice of one sort or another—that he does not understand, he looks for a monopoly explanation. And as in this field we are very ignorant, the number of ununderstandable practices tends to be rather large, and the reliance on monopoly explanation, frequent.²

Overcoming this condition of ignorance was the challenge. But how to accomplish this?

One possibility was to deepen our understanding of technology. Another possibility was to take the study of organization more seriously. Herbert Simon, also a Nobel Prize Winner in Economics, urged the latter.³ He argued for a focus on decision processes and coalition formation, rather than technology, as the basis for the theory of the firm. The influential book by Richard Cyert and James March, A Behavioral Theory of the Firm,⁴ was published soon thereafter.

That book dealt with the process of managerial decision making—with emphasis on goal formation, search, choice, organizational learning, and the like—and worked at a very microanalytic level of activity. For example, Cyert and March developed a computer model of department store pricing that predicted standard and sale prices to the penny. Albeit an impressive accomplishment, it was of much greater interest to department store managers and marketing specialists than it was to economists and other students of public policy analysis—most of whom were uninterested in the details of department store
prices but had an abiding interest in the types of customer, territorial, and other restrictions.

If anything, economists’ predilections to dismiss organization were “confirmed” by the fact that the intersection between the interests of neoclassical economic theory and the applications of behavioral organization theory appeared to be so slight. Accordingly, economists who were interested in predicting price and output and who explained nonstandard and unfamiliar business practices in monopoly terms were encouraged to believe that they could continue to ignore issues of internal organization.

“Transaction cost economics” approaches the study of economic organization differently. It asks whether economics and organization theory can be combined in a way that (more veridically) addresses the very same phenomena—horizontal, vertical, and conglomerate mergers; nonstandard and unfamiliar contracting practices—that were of interest to students of antitrust and regulation. This perspective describes firms and markets as alternative modes of governance. If firms and markets are alternative modes of organization, then the boundary of the firm needs to be derived rather than taken as given (by technology). If firms and markets are governance structures for managing transactions, then organizational rather than technological features come to the fore.

Reformulating the problem of economic organization in this combined economics and organization way, transaction cost economics advanced a rival hypothesis to that of the antitrust orthodoxy. It argued that the main purpose and effect of economic organization was not to create monopoly, but to economize on transaction costs. Not only did better explanations for many old puzzles begin to appear, but transaction cost economics called attention to and helped to explain hitherto neglected questions. For example, what are the different mechanisms through which firms and markets work that distinguish one from the other? What purposes are served by economic organization? Which transactions are organized how and why?

**What’s Going on Here?**

The very considerable accomplishments of economic orthodoxy notwithstanding, its limits become evident by examining a series of particulars.

**Vertical Market Structures**

Working out of the firm-as-production function construction in which technology is largely determinative and nonstandard forms are presumed to operate in the service of monopoly, orthodoxy held that the vertical integration (unified ownership) of successive stages of economic activity that share “technical or physical aspects” was justifiable and presumptively lawful while the integration of stages that lack these aspects was at best dubious and arguably anticompetitive.\(^5\) Consider, for example, the vertical integration of a blast
furnace and rolling mill on the one hand, and the efforts by manufacturers to prohibit franchisees from selling branded product to unauthorized dealers on the other. Because technical or physical aspects were held to be present for the first of these (in the form of thermal economies) but absent for the second, the integration of blast furnace and rolling mill was declared to be efficient and unobjectionable while the contractual restrictions were held to be unlawful. But are those conclusions correct?

**Technology Transfer**

If technology is largely determinative, then blueprints, formulas, and technical specifications and procedures will describe how to make a good or service and trained engineers will be able to transfer technology easily by having the technology described to them. If, however, the world of organization often entails "tacit judgments" and "unspecifiable skills," then we will not be surprised to learn that:

The attempt to analyze scientifically the established industrial arts has everywhere led to similar results. Indeed even in the modern industries the indefinable knowledge is still an essential part of technology. I have myself watched in Hungary a new, imported machine for blowing electric lamp bulbs, the exact counterpart of which was operating successfully in Germany, failing for a whole year to produce a single flawless bulb.⁷

**Bigger Is Better**

If organization is unimportant, then large firms will be able to do everything that a collection of small firms can do and more. The large firm will do everything as well as a small firm by replicating small firm practices where small firms do well. And because the large firm can use hierarchy to improve upon the occasional breakdowns that occur when relations between autonomous firms get out of alignment, the large firm will occasionally do better. By intervening only when expected net gains can be projected—and otherwise managing in a hands-off fashion—the large firm will never do worse (under replication) and will sometimes do better (under selective intervention).

Indeed, Tenneco, Inc. evidently had such a program in mind when it acquired Houston Oil and Minerals Corporation late in 1980. Tenneco "agreed to keep Houston Oil intact and operate it as an independent subsidiary" and to preserve aggressive incentive compensation practices in Houston that were not used elsewhere in Tenneco.⁸ As it turned out, those promises were not kept and by October 1981 Tenneco "had lost 34% of Houston Oil's management, 25% of its explorationists, and 19% of its production people, making it impossible to maintain it as a distinct unit."⁹ Given the impeccable logic of combining replication and selective intervention, what went wrong?
Threats

If firms and individuals do not know what is good for them, then we must tell them what is good for them and support it with threats. Mikhail Gorbachev, late in his career as Premier of the former Soviet Union, advised U.S. firms to “invest now,” rather than wait. He further supplied the following carrot-and-stick reasoning: “Those [companies] who are with us now have good prospects of participating in our great country [whereas those who wait] will remain observers for years to come—we will see to it.”

Accustomed, as he was, to awarding political favors and penalties to a captive population, Gorbachev thought that this same reasoning applied quite generally. U.S. firms did not comply. What went wrong?

Redistribution

If organization does not matter, then we can advise politicians on the merits of redistribution schemes by comparing actual practices with a hypothetical ideal. For example, George Stigler described the standard economic evaluation of the sugar program in the U.S. (which is a highly convoluted, politicized, and controversial program) as follows:

The United States wastes (in ordinary language) perhaps $3 billion per year producing sugar and sugar substitutes at a price two to three times the cost of importing the sugar. Yet that is the tested way in which the domestic sugar-beet, cane, and high fructose-corn producers can increase their incomes by perhaps a quarter of the $3 billion—the other three quarters being deadweight loss. The deadweight loss is the margin by which the domestic costs of sugar production exceed import prices.\(^1\)

The usual interpretation is that such deadweight losses represent inefficiency. Accordingly, politicians are routinely advised by economists to discontinue such subsidies or, if benefits must be awarded to favored constituents, to replace convoluted mechanisms by more efficient direct payments. Bad enough that politicians should resort to redistribution, but to use inefficient mechanisms is unacceptable. Politicians, however, routinely refuse good advice. Why are politicians so dense?

Transaction Cost Economics

Transaction cost economics differs from both economic orthodoxy and from more behavioral approaches to the theory of the firm. In contrast with the former, transaction cost economics holds that organizations not only matter but that they are susceptible to analysis.\(^2\) By contrast with the latter, transaction cost economics uses a combined economics and organization approach to the study of firms and markets.

Transaction cost economics is

* a comparative institutional approach to economic organization, in which
technology is de-emphasized in favor of organization, and

- the economizing action resides in the details of transactions and the mechanisms of governance.

These three elements are then combined to yield

- a predictive theory of economic organization in which a large number of apparently dissimilar phenomena are shown to be variations on a few key transaction cost economizing themes.

There are four main features to these elements: comparative institutions, economizing, details, and prediction.

**Comparative Institutions**

Transaction cost economics is always and everywhere an exercise in comparative institutional analysis. One form of organization is always, therefore, compared with one or more alternative forms of organization for accomplishing a given task. The relevant alternatives, moreover, are always feasible (as opposed to hypothetical). Inasmuch as all feasible alternatives are flawed, it becomes important to establish the strengths and weaknesses of each.

As opposed to the earlier tradition of invoking flawless government regulation as the standard remedy for “market failures,” the comparison now becomes one of flawed markets with flawed regulation. Understandably, regulation does not always win in this comparison, but sometimes it does. Ascertaining when net gains will be realized by resorting to (flawed) regulation and when transactions are better left in the (flawed) market thus entails tradeoffs. More generally, the symmetrical study of failures goes beyond market failure to include failures of long-term contracting, failures of bureaucracy, failures of regulation, and failures of government bureaus.

The upshot is that all forms of organization deserve respect, but none warrants undue respect. Accordingly, the appropriate test of “failures” of all kinds—markets, bureaucracies, redistribution—is that of remediableness: an outcome for which no feasible superior alternate can be described and implemented with net gains is presumed to be efficient.

**Economizing**

Transaction cost economics works out of an economizing perspective in which organization is featured and *farsighted but incomplete contracting* is projected. The parties to commercial contracts are thus held to be perceptive about the nature of the contractual relations of which they are a part, including an awareness of potential contractual hazards. However, because complex contracts are unavoidably incomplete—it being impossible or prohibitively costly to make provision for all possible contingencies ex ante—much of the relevant contractual action is borne by the ex post structures of governance.
Such an approach to the study of economic organization can be contrasted with the more usual effort to concentrate all of the contacting action in the ex ante incentive alignment stage of the contract (which is in the agency theory tradition). Organizations are important under the transaction cost economics setup, but they are irrelevant to agency theory precisely because these two differ on the matter of contractual completeness.

What the legal philosopher Lon Fuller has described as the study of “good order and workable arrangements”\textsuperscript{14} and the institutional economist John R. Commons has described as the combined study of “conflict, mutuality, and order”\textsuperscript{15} are very in the spirit of governance. Not only do both statements emphasize the importance of order, which is what ex post governance is all about, but Fuller emphasizes workability (feasible forms of organization) and Commons invites us to think about governance as the instrument by which order is accomplished in an incomplete contracting relation where potential conflict threatens to undo or upset opportunities to realize mutual gains. These are very different conceptions of the problem of economic organization than is contemplated by the firm-as-production function construction.

Coase introduced the idea of transaction costs as a response to this new conception, but the operationalization of transaction costs poses formidable difficulties. A key concept in the effort to operationalize transaction costs was to treat adaptation as the central problem of economic organization, of which two kinds—autonomous adaptation and cooperative adaptation—were distinguished. Upon reformulating the problem of economic organization as one of adaptation, it became natural to describe transaction costs as the (comparative) costs of maladaptation.

Two comparisons were needed. How do different transactions compare in terms of their needs for autonomous and cooperative adaptation? How do markets, hierarchies, and other modes of governance compare as instruments for effecting adaptations of both kinds? Prescribing governance structures so as to effect cost-effective relief against maladaptation hazards became the recurrent theme. The test, of course, was in the eating: Do the data support the predicted alignments between transactions and governance? The results are now in: they do.\textsuperscript{17}

Details

Although Tjalling Koopmans declared that “the task of linking concepts with observations demands a great deal of detailed knowledge of the realities of economic life,”\textsuperscript{16} that is a message that many economists have been loathe to concede. Operating, as it does, at a high level of generality, the orthodox theory of the firm appears to make it unnecessary to study the scruffy transactional and organizational details of economic life.

To be sure, economic orthodoxy deserves a great credit for explicating how a particular type of spontaneous mechanism—the market—accomplishes
price and output determination. The abiding interest of orthodoxy in the marvel of the market was not, however, matched by a parallel interest in the marvel of hybrids and hierarchies, especially as these relate to cooperative adaptations. Orthodox assumptions that property rights are well defined and that contracts are costlessly enforced by well-informed courts reinforce this neglect of transactional and organizational detail.

Transaction cost economics supplants a preoccupation with the market with a symmetrical interest in all forms of organization. Hence the details of transactions and of alternative modes of governance become significant. Contrary to the "legal centralism" tradition, according to which "disputes require 'access' to a forum external to the original social setting of the dispute [and that] remedies will be provided as prescribed in some body of authoritative learning and dispensed by experts who operate under the auspices of the state,"\textsuperscript{18} transaction cost economics holds that in "many instances the participants can devise more satisfactory solutions to their disputes than can professionals constrained to apply general rules on the basis of limited knowledge of the dispute."\textsuperscript{19} Private ordering through ex post governance is therefore where the main action resides.

The study of markets and of prices and quantities thus gives way to the study of transactions and of alternative modes of governance, with special emphasis on the mechanisms of intertemporal contracting.\textsuperscript{20} Not only do students of comparative economic organization often need to have first-hand knowledge about the phenomena in question, but the data needs are very different. Unable to work off of census and financial reports, students of organization now need to collect original data that bear directly on the issues.

\textit{Prediction}

The main purpose of science is understanding rather than prediction.\textsuperscript{21} Because, however, there are many plausible theories or would-be theories, it is important to sort the wheat from the chaff. That is accomplished by asking each to show its hand. What are the predictions? What do the data support?

The basic hypothesis out of which transaction cost economics works is that of discriminating alignment: transactions, which differ in their attributes, align with governance structures, which differ in their cost and competence, so as to effect a transaction cost economizing outcome. The simple contractual schema in Figure 1 illustrates some of the main points. For example, let us assume that there are two ways to supply a good or service to a particular customer's needs. One is by using
general purpose labor and equipment; the other is to make specialized investments in support of the customer's distinctive needs. The use of general purpose assets poses negligible hazards (hence is designated \( h = 0 \)) since, if the contract should break down, these assets could easily be redeployed to alternative productive uses. By contrast, the use of special purpose assets poses real hazards (designated \( h > 0 \)), since specialized investments cannot be redeployed without loss of productive value.

The buyer who asks his supplier to make specialized investments on his behalf has two options. One option is to ask the supplier to take his chances that the contract will work out well \((s = 0)\). The second is to introduce safeguards that deter breach and promote continuity should the contract experience trouble during execution \((s > 0)\). For example, the buyer could post a bond that could be forfeited in the event of breach. Or the buyer and supplier could create information disclosure and specialized dispute settlement mechanisms (such as arbitration), the purposes of which are to permit the parties to get through a contractual impasse and to get on with the job.

Node A in Figure 1 is the "ideal" transaction in law and economics, whereby neither party is dependent on the other \((h = 0)\) and competition prevails. Nuts and bolts, standard steel plate, copper wire, warehouse commodities more generally are all of this kind—which is to say that economic orthodoxy applies to a lot of transactions.

The case, however, where the goods or services are supported by specialized investments or otherwise pose hazards \((h > 0)\) is more interesting. Node B is the case where hazards are present \((h > 0)\) but no safeguard is provided \((s = 0)\), whence the perceptive supplier will charge a risk premium. Buyers that lack a good track record (perhaps because they are new) are unwilling to post a bond and/or ar unable to signal security in other respects, yet ask a supplier to specialize to their needs are located at Node B. By contrast, Node C is the credible commitment mode where hazards are present \((h > 0)\) but are mitigated by the creation of safeguards \((s > 0)\). Clearly the supplier will offer to supply at a lower price at Node C than at Node B.

One of the lessons of this simple schema is that contracts should be thought of as a triple in which price, the attributes of the transaction, and contractual safeguards are all determined simultaneously. The latter two are transaction cost economics supplements to the more familiar neoclassical concept of contract as mediated by price.

The above has obvious relevance to the make-or-buy decision. If the firm has needs for a generic good or service, market transactions (Node A) can be expected to work well. As transactions become more firm-specific, however, contractual hazards are posed for which cost-effective mitigation is needed. More complex modes of long-term contracting thus begin to take shape. In the limit, firms take transactions out of the market entirely and produce to their
own needs. The prediction, therefore, is that “make” eventually supplants “buy” as contractual hazards build up.

This same schema applies also to the organization of labor market transactions (especially to an examination of the efficiency benefits of labor unions), the decision to use debt rather than equity to finance a project, the purposes that are served by a board of directors (and what constituencies should be awarded votes on the board), and when deregulation will work well and when poorly. The data, moreover, are broadly congruent. As compared with the usual explanations for nonstandard and unfamiliar forms of organization (which rely on monopoly, risk aversion, and/or muscle), the predictions of transaction cost economizing are relatively powerful. Less tortured explanations for complex and puzzling phenomena thereby obtain.

**Applications**

Let us now return to the puzzles described previously and examine them through the lens of transaction cost economics.

**Vertical Market Structures**

The technological tradition holds that vertical integration and vertical market restrictions could often be justified if special “physical or technical aspects” were associated with successive stages of production or distribution, but that integration and contractual restrictions that lacked such aspects were presumptively anticompetitive. The unified ownership of blast furnace and rolling mill was thus justified because thermal economies were realized in this way. By contrast, the application by manufacturers of resale restrictions to franchisees was prohibited because the requisite technological conditions were not satisfied. Transaction cost economics takes exception with both parts of the argument.

Because transaction cost economics proceeds comparatively, the question is what form of contracting is best suited to support the governance needs of blast furnace and rolling mill. Given that thermal economics will be realized by physically siting these two stages near to each other does not necessarily warrant common ownership of both stages. In principal, each stage could remain independent and the relation between them mediated by contract. If unified ownership is preferred to contracting, that is not because thermal economies are available to the former and not to the latter. Rather, it is that siting these two facilities in a cheek-by-jowl relation to each other gives rise to a condition of bilateral dependency to which contractual hazards accrue if the two stages are separately owned. The advantage of unified ownership, then, is that it relieves these hazards and thereby facilitates adaptive, sequential responses to disturbances in a more cost effective way.

In effect, the blast furnace and rolling mill are making specialized investments in support of each other (h > 0). Absent specialized governance
safeguards, the two parties will be operating at Node B, which is a high cost node because contracts will frequently break down. The advantage of unified ownership (Node C) is that the two parties can better harmonize their interests and adapt coordinately under the auspices of hierarchy. That is a transaction cost rather than technological rationale.

To be sure, technology can and does complicate the problem of efficient contracting. The basic analytical need, however, is to assess the efficacy of alternative modes of contracting. Technology, by itself, is rarely fully determinative of organization—which is to say that there are usually several feasible modes of organization, the choice between which turns importantly on transaction cost differences. In short, organization matters.

The Schwinn case that was decided in 1967 illustrates the application of technological reasoning to vertical market restrictions. Schwinn was a bicycle firm that sold its bicycles through authorized dealers. Although Schwinn franchisees were permitted to carry other bicycles, Schwinn prohibited its franchisees from selling Schwinn bicycles to unauthorized dealers. The government declared that such restrictions were unlawful because there was no special physical or technical aspect between Schwinn and its franchisees. Indeed, the government further opined that:

Either the Schwinn bicycle is in fact a superior product for which the consumer would willingly pay more, in which event it should be unnecessary to create a quality image by the artificial device of discouraging competition in the price of distributing the product; or it is not of premium quality, and the consumer is being deceived into believing that it is by its high and uniform retail price. In neither event would the manufacturer’s private interest in maintaining a high-price image justify the serious impairment on competition that results.22

A very different interpretation emerges when the Schwinn case is examined in comparative contractual terms.23 Upon looking not at physical ties but on asset characteristics, the question is whether Schwinn has created a specialized asset that will be put at risk if no contractual restrictions are permitted. A plausible argument can be made that Schwinn has created a specialized asset (brand name capital), the value of which would be compromised if the Schwinn bicycle is sold by unauthorized dealers.

In effect, the government was assuming that Schwinn was engaged in Node A transactions, for which restrictions are unneeded because $h = 0$. In fact, however, Schwinn had created a specialized asset ($h > 0$), whence the relevant choices were Node B or Node C. By prohibiting any restrictions (safeguards), the government was denying Schwinn the benefits of Node C and locating it on Node B. As discussed above, Node B is a high cost (and, more generally, inefficient) mode.

Because, moreover, the U.S. bicycle market was competitively organized, the claims by the government of anticompetitive monopoly abuse (high and uniform retail pricing) were fanciful. The government nevertheless proceeded,
under the prevailing technological/inhospitality tradition, to argue vigorously against Schwinn, and the 1967 Supreme Court declared that the Schwinn restrictions were unlawful.\textsuperscript{24}

**Technology Transfer**

Some words become obsolete or describe imaginary conditions, but “ineffable”—incapable of being expressed in words—is not one of them. Tacit knowledge—of which the Chinese proverb that a picture is worth a thousand words and the idea of learning-by-doing are both manifestations—is a subtle condition and warrants respect. The “indefinable knowledge” to which Michael Polanyi refers in his description of industrial arts (and illustrates more generally in his deeply thoughtful book on *Personal Knowledge*) is not even contemplated, much less accommodated, by the technological tradition.

The idea, however, of contract as ex ante framework, in relation to which ex post governance fills in the details, has broad generality. Faced with the impossibility or prohibitive cost of attempting to describe a complex technology with words, blueprints, formulas, and the like, alternative ways of accomplishing technology transfer—communicating tacit knowledge—warrant consideration. In particular, the direct involvement of experienced managers, engineers, and workers in whom the relevant knowledge is deeply embedded may be needed. Combining human assets in productive teams from which others can learn is an organizational response to the technological impasse that is otherwise posed. Again, organization matters.\textsuperscript{25}

**Bigger Is Better**

Unless, for some reason, the combination of replication with selective intervention cannot be implemented as described, then large firms will always be able to do as well as a collection of small firms and will sometimes do better. Successive application of that reasoning leads, however, to the counterfactual prediction that all business will be concentrated in one large firm. Wherein does the logic break down?

The problem is that both replication and selective intervention are easy to postulate but difficult, indeed impossible, to implement. That is not evident upon examining the issue from a technological perspective for a very simple reason: the action resides in the organizational *mechanisms* through which these two processes work.

If firms and markets differ in kind, then those differences need to be identified and the ramifications worked out. As viewed through the microanalytic lens of transaction cost economics, the benefits of hierarchy (which mainly take the form of cooperative adaptation) always come at a cost: not only are incentives unavoidably degraded upon transferring a transaction from market to hierarchy, but added bureaucratic costs also obtain.\textsuperscript{26} The limits of firm size puzzle thus turns out to have organizational rather than technological origins.\textsuperscript{27} One
of the lessons is that we need to be much more self-conscious about studying bureaucracy—which is an important, complex, puzzling, and much neglected form of organization. A combined economics and organizations approach—rather than either by itself—is needed.

**Threats**

The language of power (threats) is understandably attractive when dealing with a captive population. When dealing, however, with investors who have options, the relevant language is that of credible commitments rather than credible threats. This is not an easy transformation—witness Mikhail Gorbachev’s “invitation” to American firms to invest now, and have good prospects, rather than wait, and have poor prospects, because “we will see to it” that those who wait will do poorly. If, however, Gorbachev has the latitude to punish his enemies (the laggards), what is to prevent him from deciding to expropriate his friends (those who invest now) should that suit his purposes once their investments are in place?

What Gorbachev inadvertently revealed by his words is that investing in the Soviet Union was hazardous—because politicians were little constrained by the constitution or an independent judiciary to respect investments. Accordingly, perceptive investors will make only limited and redeployable investments and will reserve larger and nonredeployable investments for other political regimes that are perceived to have superior credible commitment properties.

Rather, therefore, than harangue American business firms to invest now, Gorbachev and his successors would be better advised to get their political house in order. Presented with a credible commitment regime, American firms (and others) will respond with alacrity to the economic opportunities. Confront them, however, with legal and political hazards and they will turn elsewhere. That is a straight-forward lesson from transaction cost economics (which features hazards and their mitigation) but comes much less easily—perhaps is alien to—a more muscular power perspective. What investors require, but Gorbachev with his top-down habits could not understand, are credible commitments. Threats are inimical to that purpose. Organization matters.

**Redistribution**

If the deadweight losses of the sugar program are remediable, how is it that Stigler declared that the “sugar program is efficient. This program is more than fifty years old—it has met the test of time.”28 There are two possibilities: the losses in question are not remediable, or Stigler is wrong.

Because economists have been neglectful of mechanisms, issues of remediableness are often glossed over. It is easy to postulate hypothetical mechanisms and assume that they can be implemented. It is naive, however, to prescribe corrective mechanisms—of which lump sum transfers are an example—that cannot be implemented. The lesson of remediableness is that only feasible
mechanisms qualify. The need is to describe practicable mechanisms that can be implemented with net gains. Not only is the latter a much more demanding microanalytic exercise, but the analysis of issues such as redistribution that are the product of politics needs to be done in a way that is respectful of politics.

Thus whereas deadweight loss analysis quickly concludes that indirect and costly mechanisms are inefficient, the contractual approach to politics asks whether these mechanisms serve intended political purposes. As Terry Moe makes clear, what sometimes appear to be convoluted mechanisms are often the means by which political bargains are reached and credibility is assured. Absent, therefore, a showing that these mechanisms have broken down, a judgment of inefficiency is unwarranted. The details, once again, are where the action resides.

Concluding Remarks

The economics of organization is a huge subject and is usefully examined from several points of view. A technological perspective in which price and output are featured is one instructive approach, but should not exclude all others. The transaction cost economics point of view works out of an interdisciplinary perspective which emphasizes the importance of organization and highlights the many ways in which the mechanisms of ex post governance contribute to an economizing result. The identification, explication, and mitigation of hazards is central to this exercise. Indeed, a compact response to the query “Why do we have so many kinds of organizations?” is this: hazards come in many forms, in relation to which ex post governance structures need to be aligned in discriminating ways, thereby to relieve the hazards. To the extent to which our understanding of hazards and hazard mitigation is underdeveloped, the teaching and practice of management will benefit from more self-conscious attention to these matters. Comparative institutional analysis in which the economic importance of organization is featured will come to play a larger role in the business school curriculum if and as there is agreement that “Truly among man’s innovations, the use of organization to accomplish his ends is among both his greatest and his earliest.”

Notes

1. The quotation is attributed to Turner by Stanley Robinson, 1968, N.Y. State Bar Association, Antitrust Symposium, p. 29.
7. Ibid., p. 206.
9. Ibid.
19. Ibid., p. 4.
20. If organizations predictably undergo intertemporal transformations and/or are subject to path dependency, what are these and what are the ramifications? If large firms are prone to bureaucratization, what are the processes and what are the lessons? If politics is sometimes an integral and intentional part of the exercise, how do we make provision for that?
