A TRIBUTE TO OLIVER WILLIAMSON:

Institutions, Politics, and Non-Market Strategy

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Oliver Williamson is best known for his contributions to economics, and particularly to our understanding of how private firms are defined, operate, and change. Williamson's primary application addressed the question of why some *economic* transactions were organized within a private firm, while others took place outside of a firm, in the market. Despite this focus, Williamson's reach and impact has extended far beyond the domain of private firms and markets. Certainly suitable for a scholar who has been so vocally interdisciplinary in his approach to the study of institutions and organizations, Williamson's work has also made critical contributions to the understanding of political institutions specifically, and politics more generally.

From Transaction Cost *Economics* to Transaction Cost *Politics*

At its heart, Williamson's deep analysis of organization through the "lens of contract" is not restricted to private firms competing for economic profits. The theory and empirical analysis outlined and developed by Williamson, and those working through the framework he provides, focus on issues of *governance* more broadly: how activities, exchanges, or transactions are appropriately (or at times inappropriately) organized to minimize transaction costs. Put another way, one of Williamson's signal contributions was to note that the way in which social activity is organized has an impact on the outcomes of those activities. In this sense, Williamson's work extends far beyond the profit-maximizing firm. An understanding of governance, institutions, and organization is critical to other realms of (or transactions in) society: families, volunteer associations, and (yes) government organizations are also ruled by the same principles that Williamson develops for economic organization.

The recognition of the broad reach of Williamson's insights has led to application in other fields. Perhaps one of the most well developed is the realm of public organization—what has come to be known as *transaction cost politics*. As Dixit notes, "Transaction-cost politics views . . . policy-making as a political process constrained by asymmetric information and limited commitment possibilities."[1]

Many of the ideas, concepts, and frameworks developed by Williamson are directly applicable to the study of policy-making and policy-executing organizations. As with applications to economics, transaction cost logic applied to politics also focuses on (bilateral) dependencies between actors engaged in political transactions—whether they be governments or firms.[2] In a political world where third-party enforcement of agreements is not always possible (consider how nations may enforce international agreements) and where organizational options may be constrained (consider the types of financial incentives that may be provided to civil servants versus employees of private companies), problems of *incomplete contracting* (the inability to write down and enforce completely specified agreements to govern transactions, economic or political) and *credible commitments* (the importance of institutions that limit post-agreement renegotiation and opportunism) become both severe and unique. This in turn suggests that political organization may be governed by the same principles outlined by transaction cost logic, but with broader implications than for private firms.

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Notably, Williamson's approach for understanding political organization goes beyond normative and positive questions of public policy and the design of public institutions. In the realm of economics, Williamson's approach has had foundational contributions to the study of firm, which in turn has provided important prescriptions in the field of strategy, for scholars and practitioners alike. As Salomon notes, "Transaction cost economics is a central theory in the field of strategy. It addresses questions about why firms exist in the first place . . . , how firms define their boundaries, and how they ought to govern operations."[3] In the same way, Williamson's contributions to the study of public organization also have important implications and guidelines for scholars and executives attempting to gain traction on questions of *non-market strategy*.

In contrast to voluntary economic exchange, which characterizes the market environment of firms, the non-market environment encompasses the political, social, and legal context in which the firm operates.[4] In many settings, how firms influence and interact with their non-market environment—their non-market strategy—can have substantial implications for both the effectiveness of their market strategy and the creation of firm value. This is particularly easy to see in the wake of the recent financial crisis: pick up the *Wall Street Journal* on any given day and, in all likelihood, there will be headlines relating how government action is at the forefront of many firms' strategic agendas. This attention is paid not just to fiscal and monetary policy, but also to economic regulation. Firms in health care, financial services, and telecommunications have had and will have their opportunities and threats fundamentally defined by the nature of government activity in these areas.

Given the importance of non-market strategy to many firms' livelihoods, Williamson's contributions to this domain should not be ignored. Indeed, while less well-developed than the market applications of Williamson's transaction cost approach, it may in the end be of equal importance to managers and analysts alike. Williamson's focus on the transaction provides both scholars and practitioners of non-market strategy with two vital inputs for strategy formulation: a framework for *prediction* of non-market activity such as the actions of governments (which provides an important basis for identifying the opportunities and threats facing a particular firm); and a framework for *prescriptions* for a firm's non-market action (how a firm may fruitfully shape and influence its non-market environment). Following are examples of how Williamson's logic can be applied to understanding the nature of the non-market environment of firms.

The Organization of Regulation

Casual observers of the regulatory apparatus commonly note that government bureaucracy appears very "inefficient." This observation is often made by comparing the performance of government agencies to private firms. But how is one to evaluate such a claim? Williamson and others, through the lens of transaction cost analysis, provide an answer.

Williamson's primary point of departure is that to understand public organization, one must understand the nature of the transactions that these organizations undertake, or are charged with executing. When one takes this approach, one immediately recognizes that there may be a *selection effect* in the nature of public versus private transactions. As a simple example, consider the extension of the traditional make-versus-buy decision within firms. Williamson points out that depending on the degree of transactional hazards—i.e., the degree to which the market may fail to efficiently execute a transaction that parties view as mutually beneficial due to transaction costs—it may be more efficient to organize the high-transaction cost transactions *within* a firm and remove it form the market; whereas those transactions that have lower costs may be more fruitfully pursued *between* firms in the (open) market. Consider the application of this idea to the next stage: What happens when the firm itself is not able to efficiently mitigate the transactional hazards (or is not adapted to deal with them)? In these cases, the most appropriate organization may be the public organization—government agencies, for example.

To apply Williamson's logic more fully requires an appreciation for two dimensions in which activities of public and private organization may differ. The first is the degree of transactional hazards as traditionally viewed. In Dixit's terms—the degree to which there are information asymmetries and bilateral dependencies may make even the private firm unworkable as an appropriate way to organize a transaction. The second is the transactional hazards actually faced. One that Williamson points to, for example, is "probity"—in which the value of a transaction depends as much on procedure as it does on the ultimate instrumental outcome.[5] What this means is that the nature of the activities that "flow" to the government may be fundamentally different than those that are taken in the private sector.

An easy way to see the power of this approach is to work back from those things that are "obviously" housed in government. Foreign affairs and justice are both dominated by the public sector. Why? While issues of bilateral dependency and information asymmetries may be important, most would agree that the primary reason is so-called probity—the requirements for procedural integrity, as much as the outcome, dictates public organization of these activities. However, as we move away from these extreme cases, what happens? Is it more efficient for government to produce itself (own), regulate, or leave to the free market the disposition of financial services? What about health insurance? As we move from one activity to another, we see that the activities separate themselves into those—based on the nature of the transaction—best done privately, publicly, or by some hybrid.[6]

This allows Williamson to provide a useful answer to the question of "Why is government bureaucracy so inefficient?" An answer is: because the things is it is charged with doing may make it so. Unless we can organize an activity more efficiently outside the public agency—or without regulation—it is nothing but a thought exercise to compare it to some unattainable benchmark.[7] This is the essence of what Williamson refers to as the "remediableness" standard—namely, that we should only evaluate the so called "efficiency" of a particular activity relative to other *feasible* forms of organizing the activity, and not to an ideal that may not exist in the real world.

Williamson's insights about the design and assessment of government organizations have a number of important implications for the non-market strategy firms may pursue. On the one hand, considering how an activity may be most efficiently organized—arm's-length market exchange versus private firm versus regulated firm versus government-owned enterprise—provides *predictions* about the form of organization. On the other hand, understanding feasibility may also provide *active prescriptions* or strategies by which firms can influence their non-market environment most effectively.

Transaction Cost Politics: Predicting Environmental Policy

A prime example of the predictive power of Williamson's approach is environmental regulation. Williamson's logic of transaction costs provides predictions about how particular types of potentially harmful environmental activity will be governed.

The environmental movement in the United States dates back to the days of Teddy Roosevelt, but it really gained its modern forcefulness in the late 1960s and early 1970s. The question that faced both policy makers and firms at the time was how best to respond on the rising demands for environmental considerations. Here, Williamson provides an answer.

Could firms (even through self-regulation) or the market solve these problems at the time? The answer in many domains was "no." The reason was that the twin problems of opportunism and probity dictated a public apparatus to prosecute environmental protection. On the one hand, the potential for opportunism in environmental behavior abounds. Given that much environmentally harmful activity is hidden, firms who strike agreements to curb environmentally damaging behavior have an ability to shirk after the fact. The degree of this problem is so severe, it suggests the need for some external enforcement. However, this need creates even further potential for opportunism if firms or industries are left to entirely self-regulate. If given the charge of self-enforcement, firms may turn environmental self-regulation to gain private advantage in the market place.[8] If firms and industries cannot fully self-regulate, the alternative in the Williamsonian framework becomes government regulation.

This is precisely what unfolded in the late 1960s and early 1970s in the United States. The newly empowered environmental movement in the United States (and globally) pushed hard in that period for the creation of a regulatory apparatus to manage environmental externalities created by firms. In the United States, for example, through a series of legislative acts—exemplified by the passage of the Air Quality Act, National Environmental Policy Act, Water Quality Improvement Act, and subsequent follow-on legislation—the United States Congress created a complex federal structure for regulating environmental quality. This legislative period saw the creation of a regulatory body, the Environmental Protection Agency, charged with determining standards (rule making) and enforcing them. The roll-out of this regulation was critical to the firms in a range of industries from chemicals to steel to automobiles.

More recently, the nature of transaction hazards and the apparatus for governing them has evolved in certain areas. The ability to measure and monitor certain emissions—particularly carbon dioxide (CO_2)—has improved greatly. This has changed the nature of opportunism, reducing the ability to "game" self-regulation. In this context, many polities around the globe have adopted alternative governance for CO_2 regulation—tradable permits and so-called "cap and trade" systems. In the U.S., the creation of the Chicago Climate Exchange (a pilot, voluntary program earlier this decade) is an example of such a system. As monitoring became easier, the progressive adaptation of environmental policy from top-down, command-and-control regulation, EPA-style to more market based systems could be predicted by the transaction costs approach plied by Williamson. For firms seeking to position themselves to take advantage of their non-market environment, this has meant shifting non-market activity from a sole focus of predicting and managing their regulators (from the federal EPA to local air and water quality boards) to understanding and positioning their property rights for carbon emissions.[9]

Remediableness and Political Feasibility in Occupational Health and Safety Regulation

Moving from the realm of prediction and reaction to influence, Williamsonian remediableness also helps managers think through what strategy they should pursue in the politics of regulation. As Williamson points out, thinking about the feasibility of solutions to political hazards encompasses a broad range of considerations, including political ones. An important example is how firms manage and influence reform processes. In many cases, firms fight reforms. However, in some cases putting up a fight may be less useful than to try to co-opt them.

A classic case of such a strategy is described in Moe's analysis of the origins of the Occupational Safety and Health Administration (OSHA). As Moe recounts, knowing that standing to block the OSHA legislation would be fruitless, business interests instead pursued a strategy of compromise—in particular, they gave up their fight in exchange for some say over the design of the future agency and its policy-making and enforcement processes. As Moe notes, "If business firms were allowed to help design OSHA, they would structure it in a way that it could not do its job. They would try to cripple it. This is not a hypothetical case. Interest groups representing business actually did participate in the design of OSHA . . . [and] OSHA is an administrative nightmare, in large measure because some of its institutional designers intended to endow it with structures that would not work."[10]

Credible Commitments and International Business

One of the areas where Williamson's approach has had the greatest and most obvious impact is in the field of international business. Firms attempting to enter foreign markets must consider the non-market environment as an essential strategic consideration: how the political, social and legal environment of the country or countries they may enter will affect the outcomes they enjoy in the market; and what is the best strategy they can pursue to shape that environment to enhance their chances of success.

Consider how a firm in a regulated industry may pursue international expansion. Williamson's work implies that it is important for these firms to evaluate the degree of *credible commitment* to particular regulatory structures and policies in a candidate market. This is particularly true in a situation where the cross-national system is one of *anarchy*, in the sense that there is very limited ability—short of war or sanctions—for home nations to enforce agreements. In practice, given that these actions are very costly and will only be credible in a small set of cases, firms must rely on the domestic foreign institutions to establish commitment.

Here, the theory and evidence applying Williamson's approach to institutional analysis is compelling. Consider the case of public utilities regulation. As Levy and Spiller note, public utilities are characterized by a trio of common features: large fixed costs leading to scale and (possibly) scope economies; highly specific assets, which are very costly (or possibly even impossible) to redeploy; and competing interests over pricing and supply decisions, which may lead to political wrangling and intervention.[11] This trio of features leads to significant contracting hazards for potential entrants. Why? The first and second features create the foundations for the problem of commitment that Williamson introduced in transaction cost theory: namely, having sunk large fixed costs, utilities were at the whim of regulators to renegotiate terms with little bargaining power after the fact. While the first two problems create the *means* for opportunistic recontracting by public officials, the third feature creates the *motive*. Because utility regulation is highly contested by various interest groups in any polity, and political control in any environment is transitory (particularly when elections are fully democratic), regulated utilities are likely to encounter a political environment in the future where new constituent interests hold sway. Firms in this environment have to be wary of what the future will hold as they negotiate market concessions in the face of price regulation.

How can transaction costs be mitigated for firms pursuing international scope? The key, as Williamson would put it, is governance: in particular, the degree to which domestic political institutions can overcome transactional hazards for firms entering particular national markets.

Two aspects of domestic political institutions may ameliorate the problem of regulatory (or political) opportunism. On the one hand, a *strong and independent judiciary* may act as a check on arbitrary regulatory action. Levy and Spiller highlight the role of the judiciary in their comparative analysis of six countries' telecommunications policy:

> "The existence of an independent judiciary with a reputation for impartiality, and whose decisions are enforced, is a *necessary condition* for making these *credible commitments* . . . Countries with a well-functioning judiciary face difficulties in the short term in developing a regulatory system capable of sustaining efficient levels of private participation and investment, and there is little reason for them to devote substantial scarce resources in to such an effort. Instead, alternative mechanisms of securing commitment (like international guarantees) will be necessary."[12]

The second feature that alleviates the commitment problem for regulated utilities is the structure of policy making. If the policy-making apparatus—between executives, legislators, and agencies—cedes control and discretion to regulators, or any one political actor for that matter, the likelihood of regulatory arbitrariness increases dramatically. Alternatively, when political institutions demonstrate two conditions—multiple *veto points* and electoral systems that distribute those veto points broadly across interests—they are more likely to sustain regulatory bargains between firms and regulators.[13] Put differently, when these two conditions prevail, the *status quo* (in this case the regulatory agreements under which a firm may enter a market) becomes very difficult to change. For entering firms, this form of gridlock is good. It means the chances they will be expropriated by political actors are vastly reduced. Taken together then, the transaction cost framework provides a lens by which we can understand how to analyze the political risk facing globalizing firms: commitment is achieved by mitigating the ability of public officials to change the terms of an agreement (enhanced through multiple and distributed veto players) and by ensuring enforcement by a strong and independent judiciary.

The implication for firms preparing entry strategies should be clear. Firms that face transactional hazards should rely on comparative institutional analysis to determine how likely regulatory expropriation is to occur. Investors who ignore institutional features do so at great risk. As Levy and Spiller explain in the vivid case-in-point of Argentina's privatization of their telephone system in the early 1990s:

> "In 1990 Argentina's main state-owned telecommunications company, ENTel, was split and was later sold to two separate private consortia—one headed by Telefonica of Spain and the second headed by France Cable and Radio and Stet of Italy. The rules under which the private companies were to operate have repeatedly been changed, with pricing a vivid example: one set of pricing rules were announced when private investors were invited to bid for ENTel; these rules were changed during negotiations with the bidders; were changed twice more in 191 when the initial agreements came into conflict with broader macroeconomic polices; and were renegotiated yet again in late 1992."[14]

Conclusion

Oliver Williamson's Nobel Prize in Economics does not imply that his impact has been limited to a single field. Indeed, Olly has insisted that his colleagues, students, and most of all he himself must "be disciplined, be interdisciplinary, and have an active mind." This is a message that has had a great impact not just on the field of economics, but the broader social sciences. Take my own case as an example: my intellectual field of view since arriving at Berkeley—and being mentored by Olly—has expanded significantly beyond any self-imposed and narrowly defined disciplinary boundaries I may have operated under previously.

The implication of this ruthless search to break boundaries has meant that Olly's contributions to economics—which are impressive—are augmented by the impact he has had in other realms of inquiry. Perhaps most obvious among them is the influence Olly has had on scholars and managers interested in understanding how the legal, social, and political environment shapes and is shaped by firms.

Notes

1. Avinash Dixit, "Some Lessons from Transaction-Cost Politics for less-Developed Countries," *Economics and Politics*, 15/2 (2003): 107-133.
2. Witold Henisz and Bennet A. Zelner, "Explicating Political Hazards and Safeguards: A Transaction Cost Politics Approach," *Industrial and Corporate Change*, 13/6 (2004): 901-915.
3. Robert Salomon, 2009, see <http://blog.robertsalomon.com/2009/10/13/oliver-williamson-nobel-honoree/>.

4. David Baron, "Integrated Strategy: Market and Non-Market Components," *California Management Review*, 37/2 (Winter 1995): 47-65; David Baron, *Business and Its Environment*, 5th Edition (New York, NY: Prentice Hall, 2006).
5. Oliver E. Williamson, "Public and Private Bureaucracies: A Transaction Cost Economics Perspective," *Journal of Law, Economics and Organizatrion*, 15/1 (1999): 306-342. As Williamson (p. 322) puts it himself, "Where by probity I refer to the loyalty and rectitude with which the . . . transaction is discharged."
6. An interesting example of Williamson's logic about public organization is the recent theory on the jurisdictions of government bureaucracies. In my own work with Jason Snyder, along with that of Ting, the allocation of tasks, or policies, to agencies is explored. The basic idea of this analysis is that grouping policies together or assigning them to separate organizations—in other words, how policies or tasks are organized—has implications for how those tasks are performed. There are two main conclusions of this work. First, following Williamson, it explains why some activities—those in which the ability to provide higher powered incentives is limited—may be more tightly or "bureaucratically" controlled from the top, and thus may "flow" to the public sector. Second, it shows how the allocation of tasks to the bureaucracy may be strategic. The most stark example of this is the result that assignment of jurisdiction over policies may be driven more by the incentive to distract attention from legacy policies (that public officials do not support but cannot remove) than to ensure implementation of new policies. Indeed, work by Florentino-Cuellar et al. provides an interesting empirical example in which the design of the U.S. Department of Homeland Security reflected this type of strategic logic. Rui J. P. de Figueiredo and Jason Snyder, "A Theory of the Political Firm: A Multi-Task Model of Bureaucratic Jurisdictions," University of California at Berkeley working paper, 2001; Michel Ting, "A Theory of Jurisdictional Assignments in Bureaucracies," *American Journal of Political Science*, 46/2 (2002): 364-378; Dara Kay Cohen, Mariano Florentino-Cuellar, and Barry R. Weingast, "Crisis Bureaucracy: Homeland Security and the Political Design of Legal Mandates," *Stanford Law Review*, 59/3 (2006): 673-724.
7. Williamson (1999), op. cit., p. 328.
8. We will see an example of such activity in the example of occupational health and safety regulation in the following discussion.
9. Baron (2006), op. cit., pp. 366-383.
10. Terry M. Moe, "The Politics of Structural Choice: Toward a Theory of Public Bureaucracy," in Oliver Williamson, ed., *Organization Theory* (New York, NY: Oxford University Press, 1990); cited in Oliver Williamson, *The Mechanisms of Governance* (New York, NY: Oxford University Press, 1996).
11. Brian Levy and Pablo T. Spiller, "The Institutional Foundations of Regulatory Commitment: A Comparative Analysis of Telecommunications Regulation," *Journal of Law, Economics and Organization*, 10/2 (1994): 201-244; Brian Levy and Pablo T. Spiller, eds., *Regulations, Institutions and Commitment: Comparative Studies of Telecommunications* (New York, NY: Cambridge University Press, 1996).
12. Levy and Spiller (1994), op. cit., pp. 209-210 [emphasis added].
13. See Levy and Spiller (1994) and (1996), op. cit. Also, see Witold J. Henisz, "The Institutional Environment for Economic Development," *Economics and Politics,* 12/1 (2000): 1-31.
14. Levy and Spiller (1994), op. cit., p. 237. Indeed, in a broader scale data analysis, Henisz and Zelner find that the higher the degree of regulatory commitment, the greater the investment by private firms. As they summarize their results, "[Variation in] checks and balances on executive discretion . . . created by . . . political structures and party systems affects relative rates of basic telecommunications infrastructure deployment in 147 countries during the period 1960-1994." Witold J. Henisz and Bennet A. Zelner, "The Institutional Environment for Telecommunications Investment," *Journal of Economics and Management Strategy*, 10/1 (2001): 123.

California Management Review
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