

THE THEORY AND PRACTICE OF CONTRACTING

ESRC Centre for Business Research, University of Cambridge
Working Paper No. 78

Simon Deakin
ESRC Centre for Business Research
Studies
Department of Applied Economics
University of Cambridge
Sidgwick Avenue
Cambridge CB3 9DE

Phone: 01223 335242
Fax: 01223 335768
Email: sfd20@econ.cam.ac.uk

Jonathan Michie
Dept. of Management & Business
Birkbeck College
University of London
London
WC1E 7HX

Phone: 0171 631 6000
Fax: 0171 631 6270
Email: j.michie@mbs.bbk.ac.uk

December 1997

This Working Paper relates to the CBR Research Programme on Corporate Governance, Contracts and Incentives

Abstract

This paper explores possibilities for theoretical synthesis in the study of contracts and reviews recent empirical research on contract process in both the public and private sectors. It argues for an interdisciplinary approach in which insights from organisation theory and social systems theory are integrated with those of transaction cost economics. Such an approach may prove particularly valuable for the study of inter-organisational relations and trust. From this perspective, case studies, institutional histories and legal-conceptual analyses may all be used to advance the understanding of current changes in economic organisation.

Acknowledgements

The support of the Economic and Social Research Council is gratefully acknowledged. The work formed part of the ESRC Contracts and Competition Programme. We thank Christel Lane, Steve Pratten, Jochen Runde, Giles Slinger and Frank Wilkinson for comments on an earlier draft.

THE THEORY AND PRACTICE OF CONTRACTING

Introduction

If there is a single strand which runs through the changes wrought by the neoliberal revolution in economic policy and management in Britain over the past two decades, it is the revival of contract as the foremost organising mechanism of economic activity. The process which began with privatisation and deregulation has been transformed into a radical reshaping of organisational forms and boundaries in both the public and private sectors. Market disciplines have taken new and strengthened forms as a result of the introduction of quasi-markets in the public health and education sectors, the separation into competing units of the former nationalised utilities, and the greater use by organisations in all sectors of outsourcing and sub-contracting of goods and services. The task of overseeing these changes has fallen to competition policy, a hitherto-neglected area of law and administrative practice whose influence is now felt across a growing range of economic and social issues.

Many of these changes have been inspired by a belief in the primacy of market forces as a mechanism for the efficient allocation of resources, and a suspicion of state ownership and management of the economy. The basis for this approach can be described in broad terms as economic, in the sense that economics has provided the most systematic theory of how markets work under conditions of decentralised exchange. However, while economics has an impressively extensive and formal theory of *exchange*, it does not have a correspondingly extensive theory of *contract*. The formal proofs associated with the Arrow-Debreu theorem assume a more-or-less frictionless world of complete information, perfect foresight and costless transacting. It is only under these obviously atypical conditions that the 'fundamental theorem of welfare economics' - the proposition that the allocation of resources in a state of competitive market equilibrium is welfare-maximising - can be said to hold. The 'realisation that this paradigm is insufficient to accommodate a number of important economic phenomena' has led theoretical economists to focus on 'the process of contracting - particularly its hazards and imperfections - [as] a natural way to enrich and amend the idealised competitive model in an attempt to fit the evidence better' (Hart, 1990:

163). This is the area carved out since the early 1970s by the economics of information and insurance, by principal-agent theory and by game theory.

Yet as soon as we step outside the core market paradigm of modern neoclassical economics, a number of questions are posed which may, perhaps, require more than mere amendment of the basic model. How are markets constituted? What are the forces which account for the emergence and growth of firms? What are the natural limits to private ordering? What precisely is the contribution to economic activity of private law? Under what circumstances (if any) does regulatory law have a role to play in promoting welfare? These questions, in turn, raise issues concerning the choice of organisational form and regulatory framework which economics has barely begun to address. Perhaps surprisingly, given the confidence of policy-makers in their capacity to redraw the boundaries between markets and organisations, economics has offered only limited and partial explanations 'for the observed pattern of coordination within the economic system and, in particular, why certain activities are coordinated in different ways (e.g. market versus firm, short-term versus long-term contracts, etc.)', with the result that 'economic theory offers little basis for the normative analysis of and choice among alternative instruments of coordination' (Medema, 1996: 571).

The elaboration of a theory capable of answering these questions has become the objective of the 'new institutional economics', the body of work which has developed from Coase's insights into the nature of transaction costs and their implications for organisational form. According to Oliver Williamson, transaction-cost economics 'is, by construction, an interdisciplinary approach to economic organisation in which law, economics and organisation are joined' (Williamson, 1995: 22), although he adds that 'economics is the first among equals' (Williamson, 1996: 3). In this chapter we will argue that a coherent, interdisciplinary analysis is still in the process of developing, and that for progress to be made in this area it is essential for economics to recognise the contributions of related disciplines. 'Economic imperialism', or the broad application of economic reasoning (in practice, predominantly based on price theory) to both market and non-market situations,¹ must be rejected. Far from offering an integrated approach, this type of analysis consists of expanding the scope of

neoclassical economics at the expense of other social science disciplines. A truly *interdisciplinary* approach implies that the methods and insights of each of the relevant disciplines are modified and improved by the encounter between them. In this sense, new institutional economics can only advance further if it accepts that insights from other disciplines are needed in order to achieve a more complete understanding of contractual processes; it also implies that the process of seeking synthesis with other disciplines is one with the potential to transform and improve economic theory itself.

To explore further the possibility of disciplinary synthesis, we review below the current state of contract theory in a number of related areas in economics, law and social theory, and we examine the points at which they overlap or intersect. We then consider the impact of recent empirical work on the *process or practice of contracting* carried out under the ESRC's Contracts and Competition Programme and related initiatives.² Our focus here is on the particular issues raised by inter-firm or inter-organisational contracting. This is a particularly important area for analysis, as changes to the structure of markets and organisations in both the public and private sectors have led to contractual relations displacing bureaucratic forms of coordination. An understanding of the forces at work in this process of transition is of paramount importance for both theory and policy. In this context, we will argue that while it is premature to speak of a new interdisciplinary paradigm which is ready to replace the separate approaches of the different disciplines which are concerned with the study of contracts, we can nevertheless identify a degree of convergence around certain key conceptual issues, in particular those relating to the meaning of inter-organisational cooperation and trust.

Disciplinary Perspectives on Contract

Transaction cost economics and the Coase theorem

We start with the basic propositions developed by Coase in the context of his analysis of transaction costs, and which are the common source of both new institutional economics and the modern economic analysis of law. Extensive reference to the Coase theorem by lawyers and economists has tended to mask some important and revealing ambiguities. Coase's starting point in 'The problem of social cost' is to

regard the subject-matter of exchange as legal rights - in particular, rights over the use of resources - as opposed to physical commodities. He then poses the question of under what circumstances efficiency is affected by the legal rules which determine the respective rights and liabilities of economic agents. The 'Coase theorem' holds that the determination of legal rights makes no difference to efficiency in a zero transaction cost world, since the rights in question will be re-allocated through exchange until they reach their most efficient use. In other words, in a world where contracting is costless and there are no barriers to exchange, the competitive process will bring about a Pareto-optimal outcome (in other words the state in which further reallocations cannot be made except by making at least one agent worse off). Under these conditions, all externalities are internalised³ and private and social costs are completely aligned.⁴

If this were all that Coase had said, it would have amounted to no more than a footnote to the general model of competitive equilibrium. However, it would seem that Coase had something else in mind, namely the development of a framework for analysing the economic role of law in real-world situations of high transaction costs. This interpretation is consistent with his earlier insight in 'The Nature of the Firm' that 'the distinguishing mark of the firm is the supersession of the price mechanism' (Coase, 1937: 38) - the term 'supersession' here indicating that the mechanisms of coordination within firms are qualitatively distinct from those in the market. In 'The Problem of Social Cost', Coase wrote that

if market transactions were costless, all that matters (questions of equity apart) is that the rights of the various parties should be well defined and the results of legal actions easy to forecast. But... the situation is quite different when market transactions are so costly as to make it difficult to change the arrangements of rights established by law. In such cases the courts directly influence economic activity. It would therefore seem desirable that the courts should understand the economic consequences of their decisions and should, wherever possible without creating too much uncertainty about the legal position itself, take these consequences into account when making their decisions. (Coase, 1960: 119.)

Perhaps the least important aspect of 'The Problem of Social Cost' is the Coase theorem itself, which appears to be simply the platform on which a much more extensive framework is to be constructed for the analysis of real-world contracting problems. Reviewing the treatment of his works by the economics profession, Coase wrote in 1988 that 'my point of view has not in general commanded assent, nor has my argument, for the most part, been understood' (Coase, 1988: 1), in large part because 'the world of zero transaction costs, to which the Coase Theorem applies, is the world of modern economic analysis, and economists therefore feel quite comfortable handling the intellectual problems it poses, remote from the real world though they be' (1988: 15).

Nor can Coase be said to be ruling out state intervention or market regulation *per se*. Although this is often taken to have been his intention in attacking the use of Pigouvian taxes as a solution to externalities, Coase himself has recently reiterated that it was no part of his argument to reject a role for the state on *a priori* grounds.⁵ Solutions may be possible through the legal allocation of property rights or through the imposition of liability rules (that is, determining liability for private law wrongs such as torts or breaches of contract) and 'from these considerations it follows that direct governmental regulations will not necessarily give better results than leaving the problem to be solved by the market or the firm'. But at the same time, 'there is no reason why, on occasion, such governmental administrative action should not lead to an improvement in economic efficiency'. (Coase, 1960: 118).

One possible interpretation of this statement is that the economic role of the law is a function of the intensity or extent of transaction costs. For this purpose, transaction costs can be defined in either a narrow or a broad sense. Narrowly conceived, they refer to the costs of making, monitoring and enforcing contracts (Dahlman, 1979: 148; Coase, 1988: 6), but, more broadly, they can be thought of as including any kind of barrier to efficient, decentralised exchange. This category would include, therefore, not just informational constraints and limits on human foresight and cognition, but also incomplete or 'missing' markets and strategic or non-cooperative behaviour on the part of agents. Although this wider definition has been said to reduce the Coase theorem to the level of a tautology (Cooter, 1990: 67), this does not greatly matter if we take the view that Coasian analysis is

essentially concerned with the nature of institutional responses to market failure, rather than with the rather peculiar properties of the zero transaction cost world.⁶

It remains the case that the effort devoted by economics to the analysis of pure competition dwarfs that invested in understanding the economic role of institutions and organisations. The work which might build on the foundations laid by the Coase theorem is still in its infancy. In particular, there are a number unresolved issues relating to this mode of analysis. The first is concerned with mechanisms of equilibrium in the 'real world' of positive transaction costs. In the Coasian model of the firm, transaction costs are minimised through a 'moving equilibrium' - 'a firm will tend to expand until the costs of organising an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organising in another firm' (Coase, 1937: 55). Does this mean that observed institutional forms are, similarly, in a state of equilibrium of this kind? In 'The Problem of Social Cost' Coase refers more cautiously to the need 'to compare the total product yielded by alternative social arrangements' when evaluating different modes of coordination, and does not state that efficient institutional solutions evolve by virtue of an equilibrating mechanism. It is plausible to argue that since the Coase theorem starts off from a general-equilibrium framework (as does his model of the firm), institutional responses to market failure represent 'second-best' 'partial solutions. In other words, the basic model is still driven by a market analysis, and price is still the principal mechanism by which markets clear and allocative efficiency is reached. This, as we shall see, is the view largely adopted by the economic theory of contract. However, it does little to illuminate the notion that alternative forms of coordination *supersede* (to use Coase's term) the price mechanism in circumstances where decentralised exchange gives rise to high transaction costs. In what precise sense is the price mechanism both 'superseded' and yet still, distantly, effective?

This leads on to the second set of issues which are concerned with the normative implications of Coasian analysis. In conditions of high transaction costs, the response of policy-makers could take one of a number of forms, depending on the nature of those costs. One possibility is that since the efficiency of resource allocation depends on

economic agents being able to contract at low cost, the law should seek to reduce barriers to exchange and to give as wide an ambit as possible to property rights and to freedom of contract. This option - which in the vast majority of modern law and economics analyses is the *only* normative interpretation of the Coase theorem to which any weight is attached - implies a legal regime of minimal regulation, since any constraint on freedom of disposition and freedom of contract can be read as reducing competitive intensity and introducing market distortions. However, a different interpretation is that unregulated markets are necessarily characterised by high transaction costs, arising from limits on the availability of information and other barriers to exchange; in these cases, the role of the law is not to promote market competition *as such*, but instead to underpin non-market institutions (including but not limited to the firm) in order to ensure the more effective coordination of economic resources. This implies a focus on the efficiency-enhancing properties of liability rules and regulations. While such an approach is not commonly associated with the economic analysis of law, it is, arguably, fully compatible with Coasian techniques.

Contract and economic theory

The idea that barriers to efficient exchange can be overcome through private ordering forms the basis for contract theory in economics. Contracts, by specifying the rights and obligations of the parties in various future states of the world, supply incentives for the efficient sharing of risk and information. Principal-agent models analyse situations in which information is unevenly or 'asymmetrically' distributed between contracting parties with potentially divergent interests. The most commonly-analysed relationships are those in which one party acts on the other's behalf, as is assumed to be the case in employment, agency or franchise agreements. Adverse selection, prior to the contract, and moral hazard, during its performance, arise where the 'principal' cannot costlessly observe or monitor the 'agent's' characteristics and/or actions. A specialised incentive structure is needed to achieve an optimal allocation of resources. The issue, then, is to identify the optimal compensation scheme through which the principal can induce the agent to act in such a way as to maximise the principal's utility.⁷ This has given rise to an extensive literature examining the structure of particular contracts (such as piece-work

contracts or share-cropping arrangements) in which pay-offs are linked in various ways to inputs and/or outputs of the agent in such a way as to maximise gains from trade.⁸

Other, related models focus on the uneven distribution of risk. Where one party is more risk averse than the other, contract terms can be used to provide the former with an element of insurance. Certain features of employment contracts, such as wages which are fixed independently of individual productivity and implicit promises of job security, have been analysed in this way. For example, the setting of a fixed wage rate is seen as an 'income-smoothing' device which minimises the uncertainty which would arise if the worker were paid strictly according to variations in his or her marginal revenue product.⁹

Much of the work in the principal-agent area assumes that optimal contractual solutions can be achieved at low or minimal cost, in the sense that the parties can arrive at a 'complete' contract which specifies their rights and obligations in all relevant future states of the world, which can be costlessly enforced and need not be renegotiated. There is something of a contradiction here - the theory acknowledges that constraints on information exist at the level of the principal's capacity to observe the agent's characteristics and behaviour, but takes little account of the transaction costs of designing and implementing the incentive structures which contracts are understood to embody. This inconsistency is all the more problematic, given the extreme complexity of the contractual arrangements which many of the more formal models predict (e.g. Rosen, 1985). It also leads to an undue focus on the actions and behaviour of the agent, when, from the agent's point of view, the possibility of a withdrawal of cooperation by the principal is, presumably, a relevant consideration.¹⁰

Partly as a result of these difficulties, more recent work has focused on the issue of contract incompleteness.¹¹ An incomplete contract is one which 'will be silent about the parties' obligations in some states of the world and will specify these obligations only coarsely or ambiguously in other states of the world' (Hart, 1995: 23). The costs of incompleteness are increased where the parties contemplate a long-term relationship as the basis for maximising the joint revenue from production, and hence are, to varying degrees, locked into a particular arrangement. Specific costs include the costs of anticipating all future

relevant contingencies and specifying the parties' rights and obligations in those situations, the difficulties of third-party enforcement (which depends on the effectiveness with which claims can be verified and sanctions implemented) and the costs and risks associated with renegotiation under conditions where one party may be able to subject the other to 'hold-up'. One suggested solution to the costs of incompleteness is vertical integration, or the unification of ownership rights over productive assets in the hands of one of the two contracting parties. The essence of the firm, from this point of view, lies in the employer's control over the *non-human* assets of the business (Grossman and Hart, 1986; Hart, 1989; Hart and Moore, 1990). 'Managerial prerogative' is simply the right, which is inherent in any form of ownership, to determine the use of the property in question and, in the last resort, to exclude others from access to its use or enjoyment. It is this which gives the employer the right to direct the form and pace of production and to resolve issues of contract incompleteness without the need for renegotiation - 'control over non-human assets leads to control over human assets' (Hart, 1995: 57).

A parallel literature has grown up applying many of these ideas in the context of the economic analysis of law. A clear role for contract law has been identified, in terms of supplying 'default rules' or standard terms which most parties would contract for, but for the high transaction costs of making formal agreements, and which apply in the absence of contrary agreement. The principal functions of the rules governing liability are to facilitate exchange and reduce the net costs of breach of contract (Posner and Rosenfield, 1977; Kronman and Posner, 1979: ch. 1). More specifically, rules governing mistake and misrepresentation can be seen as 'lubricating' exchange by providing incentives for the efficient production of information (see Kronman, 1978; Bishop, 1983). The exceptional nature of the remedy of specific performance and the tendency of contract damages to under-compensate the victim of breach by comparison to the actual extent of losses incurred (in particular as a consequence of the mitigation and remoteness rules) has been explained in terms of the high information costs confronting courts when it comes to ascertaining and verifying the terms of contracts and implementing remedial sanctions (Kronman, 1977, 1985; cf. Schwartz, 1979).

Nevertheless, many issues concerning contract form and duration, on the one hand, and the relationship between private ordering and the rules of contract law, on the other, remain far from clear. A leading contract theorist has noted the failure of economics to answer the following 'very basic question': 'Why do parties frequently write a limited term contract, with the intention of renegotiating this when it comes to an end, rather than writing a single contract that extends over the whole length of their relationship?' (Hart, 1990: 178). Implicit in this formulation are other important but unanswered questions concerning the optimal level of contract formality and enforceability. It is far from clear, in particular, how far the law should seek to attach legal significance to the 'implicit contracts' recognised by economists, which may be no more than understandings or assumptions which may or not qualify as implied terms according to the established legal tests for 'gap filling' in contracts. If such terms are recognised as legally binding, what are the optimal sanctions for their breach?¹²

Game theory, which studies the 'strategic' behaviour of an economic agent in response to the anticipated moves of others, has come to play a growing role in the analysis of these issues. The success of strategies for future cooperation between contracting parties depends on how far each one calculates that it is in his or her self-interest not to breach or 'defect' from the arrangement, *given the likely behaviour and response of the other*. The 'Nash equilibrium' describes a situation in which each party adopts and maintains a strategy which will maximise its own interest, given the choice or strategy of the other(s). An essential point here is that a Nash equilibrium does not necessarily represent a state in which the allocative efficiency of society's resources is maximised; moreover, multiple Nash-equilibria are possible, depending on the precise circumstances in which the 'game' is played. Contrary, then, to traditional analyses of the welfare effects of exchange, exchange based on self-interest may lead to a sub-optimal outcome, as illustrated in the much-analysed prisoners' dilemma game.¹³

It has been shown that under circumstances of repeated exchange, there is a greater likelihood that strategies of cooperation will prevail, as each party now calculates that the costs of defection include the prospect of retaliation by the other party in future rounds of bargaining (Axelrod, 1986). One interpretation of this result is that longer-term contracts, by their nature, may be self-enforcing. However, for complete self-

enforcement, there would have to be an infinite number of exchanges, since once the terminal date of the relationship is known, the parties enter a bargaining 'endgame' in which it becomes rational for each party to defect in response to the impending defection of the other.¹⁴ The problematic assumption of infinite trading can be replaced by the more realistic possibility of an *indefinite* relationship, and this offers a potentially revealing insight into contracts of indeterminate duration, such as employment contracts. But even here, there remains the problem that renegotiation of the contract terms may become necessary at some point in the life of the relationship, or may arise from one party acquiring a temporary market advantage from which it can dictate new terms of trade. The conditions under which long-term contracts can be written so as to be 'renegotiation-proof' are so extreme as to have only a tenuous connection with agreements of the kind which are observed in practice, if, indeed, they can be stated formally at all, which some doubt (Harsanyi and Selten, 1988).

Game theory, then, is far from establishing that self-enforcing agreements are the norm. On the contrary, it would seem to imply the possibility of a substantial role for institutional enforcement of various kinds. Here, mechanisms such as reputation and private ordering,¹⁵ on the one hand, and the liability rules of contract law, on the other, may offer complementary rather than mutually-exclusive explanations.¹⁶ Game-theoretical reasoning can be deployed, for example, to show that, in the absence of institutional regulation, private ordering can lead to sub-optimal outcomes in bargaining relationships, in particular where the relation is affected by asymmetric information (Gillette, 1990; Ayres and Gertner, 1992; Aghion and Hermalin, 1992). Under these circumstances, limitations on freedom of contract may produce Pareto-superior allocations, contrary to the normal finding of the economic analysis of law that contractual restrictions are sub-optimal. This idea could embrace, for example, rules which penalise opportunistic renegotiation or termination of contract terms, thereby stabilising trading relationships and penalising hold-up or defection.¹⁷

One implication of these models, then, is that unfettered competition may not be welfare-maximising, and that regulatory interventions may increase economic welfare. Distributional issues also re-enter the picture, given that imperfections which arise from asymmetric information between, for example, employers and employees are 'at

least partly, determined by the distribution of wealth' (Stiglitz, 1986: 15-16). These are interesting results, given that the economic theory of contract retains neoclassical assumptions about the rationality of individual behaviour, and has made virtually no use of wider sociological or historical perspectives on institutional forms. The question is whether the progress made in the economic understanding of contract can be continued unless such an engagement with other areas of thought is made.

New institutional economics

The status of the 'new institutional economics' (or NIE) as a distinct area has been blurred by the movement of formal economic theory into the analysis of long-term and incomplete contracts. Moreover, transaction cost economics, the main plank of the NIE, has its roots in roots in neoclassical thought, and not in the heterodox 'old institutionalism' of, among others, Veblen and Commons.¹⁸ Williamson has described transaction cost economics as 'different from, but not hostile to, orthodoxy' (1996: 3), and has cited a number of differences (1996: 6-10). Above all, transaction cost economics departs from the 'stronger rationality assumptions' of orthodoxy, in favour of 'bounded rationality', or the idea that there are inherent limitations upon human foresight and cognition. This involves a rejection of 'hyperrationality' of the kind used, for example, in game theory to predict agents' behaviour over extended periods of time. Williamson also asserts that contracting parties are prone to behave opportunistically, that is on the basis of 'self-seeking with guile'. As a result, '[a]ll complex contracts are unavoidably incomplete by reason of bounded rationality, and the convenient concept of contract as promise (unsupported by credible commitments) is vitiated by opportunism' (1996: 6). Neither principal-agent theorists nor game theorists would have much difficulty with the concept of opportunism in this sense, but it seems unlikely that they would be prepared to accept the notion of bounded rationality, a common view being that 'a satisfactory formalisation of [this idea] does not yet exist' (Hart, 1990; although cf. Hart, 1995: 23).

This relates to a second fundamental difference, which is one of approach and orientation. Mainstream economic theory is largely concerned with models in which economic systems are self-equilibrating. It is against this background assumption that economic

theory makes use of mathematical and other formal analytical techniques for modelling contracts. This branch of economics is less interested in institutional forms, on grounds that it is too difficult to achieve a formal representation of the complex social phenomena which are associated with contracting.¹⁹ By contrast, '[t]ransaction cost economics eschews hypothetical ideals and insists that the relevant comparisons are with feasible alternatives, all of which are flawed' by comparison with allocations based on pure competition (Williamson, 1996: 7). A close focus on the comparative properties of institutional and organisational forms follows from the Coasian approach of viewing firms and markets as *alternative* modes of coordination. Williamson has recently added 'hybrids' or inter-organisational networks as a third, alternative mode, thereby directly incorporating insights first developed in organisation theory.²⁰

The essence of Williamson's account of contractual governance is that particular mechanisms or structures will emerge as a response to the characteristics of transactions, in terms of the degree of asset specificity (the extent of relation-specific investments) and the frequency of contracting. The resulting contract forms will be efficient in the sense that they represent 'an outcome for which no superior alternative can be described and implemented with net gains' (1996: 7). Williamson's economic treatment of contract law draws on the work of Macneil (1974, 1978), and his threefold classification of contract law into 'classical', 'neoclassical' and 'relational' types. This provides the basis for a theory which seeks to explain contract form and duration, and the extent of legal enforcement of contracts. According to this, 'classical' contract law operates effectively for discrete or one-off transactions characterised by a low degree of asset specificity and uncertainty, and where little or no repeat trading is envisaged. The short-term orientation makes it appropriate to regard the contract as fully expressing all the future rights and obligations of the parties ('presentation'), while the absence of relation-specific investments means that opportunism can be effectively countered by the threat of exit from the relationship ('market governance') or by resort to the courts, which, because of the unlikelihood of repeat trading, does not involve the loss of significant future goodwill.

Where the parties to contracts make relation-specific investments which cannot be redeployed at low cost, the usefulness of the 'classical' model

is limited since the express terms of the contract can no longer specify all future contingencies. Nor can one party use the market mechanism of exit to limit the threat of opportunism by the other, since this would mean foregoing the chance to realise relation-specific investments. Williamson suggests that these conditions give rise in the first instance to 'neoclassical contracting', in which the parties accept at the outset that the agreement is incomplete, in the sense of being unable to specify their rights and obligations in all future states of the world, but nevertheless attempt to use their agreement to plan for future contingencies by other means. This is expressed in the use of mechanisms of 'trilateral governance', including hardship and arbitration clauses.

At a further extreme, where increasing uncertainty and asset specificity together with repeat trading make the parties more highly dependent on each other, transaction cost analysis predicts the emergence of 'relational contracting'. The formal contract or agreement is now less important as a reference point for dispute resolution than the continuing relationship. The interest both parties have in maintaining the relationship, which derives from the absence of a viable substitute contract, means that contracting of the 'neoclassical' kind is, in one sense, unnecessary, since it is in the parties' self-interest to adjust flexibly to changing circumstances; in another sense, neoclassical contracting is ineffective for the resolution of the disputes which arise in this situation since the generic mechanisms which it deploys, such as hardship clauses, are not sufficiently flexible to resolve the disputes which may arise in the course of a specific relationship (Williamson, 1985: 77). One option here is vertical integration, signifying the displacement of inter-firm relations by 'unified transactions' taking place within the firm, but an alternative is complex 'bilateral governance' between autonomous organisations. Franchising, customised sub-contracting, joint ventures and similar arrangements come into this category of 'hybrid' or 'network' relations (Powell, 1990).

It is not, however, simply a question of contract forms being matched with the characteristics of certain transactions, in terms of asset specificity and frequency; these contract forms, in turn, are matched with certain types of legal governance. Hence Williamson suggests that 'each generic form of governance - market, hybrid, hierarchy - needs to

be supported by a different form of contract law' (1996: 95). His notion that intra-firm relations are supported by a form of contract law which he calls 'forbearance', or reluctance to deploy or make provision for external legal supervision, seems to refer more to a form of contractual practice than to legal doctrine. Nevertheless, other analyses have suggested that particular variants of contract law can be identified with certain transaction-types, such as the employment law (Masten, 1988; Marginson, 1992; Deakin and Wilkinson, 1996), collective labour law (Summers, 1972) and franchising law (Hadfield, 1990; Joerges, 1991).

However, this theme is underdeveloped in Williamson's own work. In his most recent work (1996), he takes as his theme institutions as 'mechanisms of governance' at the 'microanalytic level', as opposed to the institutional environment of formal rules. Indeed, the efficiency implications of transaction cost economics do not, it seems, extend to the latter. For the purposes of analysing the processes by which economic agents 'align transactions with governance structures to effect economising outcomes', the institutional environment is taken as a given (1996: 5).

This leaves open the fundamental issue of how institutions should be regarded in economic analysis, in particular from the point of view of evolutionary processes. One influential view which stems from certain versions of game theory is that institutions, as such, are undeserving of analysis, since they simply represent observed patterns or regularities of behaviour (Schotter, 1981). As Ménard (a critic of this view) puts it,

the set of possible rules is restricted to 'regularities' based on common knowledge acquired by the agents who behave *rationally*; they conform to these regularities because they calculate the advantages of doing so. Therefore institutions are conceptualised as *patterns of behaviour* implemented through repeated actions of agents as they deal with recurrent problems. Emphasis is shifted from rules to regularity of behaviour. (Ménard, 1995: 165.)

As Ménard comments, the basic problem with this approach is that it assumes too much 'omniscient calculation' and access to dense information, and it must be seen as incompatible with a 'new institutional' approach which rejects 'hyperrationality'.

A slightly different approach holds that while legal institutions cannot be reduced to the level of observed regularities, they are nevertheless subject to a process akin to natural selection, whereby inefficient rules are discarded through the pressures of litigation. In a case-law system, precedents form a 'capital stock' of legal ideas on which litigants can draw and from which the courts will choose more or less efficient rules, discarding others (Posner, 1993; Priest, 1977). A different but nevertheless related idea is expressed by Hayek's conception of the common law as both the outcome of and the basis for 'spontaneous order' (Hayek, 1983). The precise mechanism by which evolutionary processes would work in civilian systems, where judge-made law is less important (although far from negligible), has never been explained (for discussion see Mattei and Pardolessi, 1991). More generally, there is reason to doubt that evolutionary processes operate smoothly in institutional settings.²¹

North has put forward a theory of the institutional framework which portrays legal and other institutional rules as both separate from individual agency, and as responding only slowly and imperfectly to pressures for change. He suggests that 'institutions form the incentive structure of a society, and the political and economic institutions, in consequence, are the underlying determinants of economic performance' (1993a: 359). The principal force for change in the form of institutions comes from competition between organisations (such as firms) which must adapt to survive, but there is no assumption that the process is efficient, in the sense of producing optimal outcomes, because 'economies of scope, complementarities, and network externalities of an institutional matrix make institutional change overwhelmingly incremental and path dependent' (North, 1993b: 17). North nevertheless argues that institutions are endogenous to the process of economic development, and that the enforcement of property rights through 'credible commitments' has been a major force for growth in the modern period:

Formal rules are an important part of the institutional framework, but only a part. To work effectively they must be complemented by informal constraints (conventions, norms of behaviour) that supplement them and reduce enforcement costs... [but] we know very little about how informal norms evolve. (North, 1993b: 20).

Here, institutions are seen principally as *constraining* individual agency. As elsewhere in mainstream economics, the preferences of agents are taken as given (or as exogenous, or pre-formed), but now, in addition to agents adjusting their behaviour to prices (as in neoclassical theory), they also do so in relation to the overall 'incentive structure' of society. In other words, legal norms, along with other formal and informal rules, impose constraints to which individual agents respond in a rational, calculative manner. This is in contrast to a strand in 'older' institutional theory which sees institutions as shaping cognition and preferences and which is currently undergoing a revival in organisation theory, to which we now turn.

Organisation theory and social systems theory

Neoclassical economic thought rejected the view that agents' preferences are shaped by institutional forces, such as habits, routines and laws, in favour of the idea that preferences must be taken as exogenous, and this position has held sway in orthodox analysis for over half a century. The indifference of most economists to the work of sociologists and organisation theorists has been reinforced by the tendency of the latter to describe rule-orientated behaviour as 'non-rational'. More recently, however, attempts have been made to place the phenomenon of individual economic rationality within a broader institutional theory of economic organisation (March and Olsen, 1989; Powell and Di Maggio, 1991; Scott and Meyer, 1994; Scott, 1995). This holds that 'institutional forces encompass and subsume rational ones. The rules of rationality are set by institutional processes and vary from one institution to another' (Scott, 1995: 152).

Institutions are seen as containing regulative, normative and cognitive elements or components. The principal contribution of the more recent developments in economic sociology is to stress the role, above all, of *cognitive* factors (see Powell and Di Maggio, 1991), in contrast to the focus of earlier analyses on regulative and normative influences. The stress on cognitive elements promises to throw light on issues relating to conceptions of individual agency and behaviour which are highly relevant to economics, and may help to advance understanding of the concept of 'bounded rationality'. In this regard, the work of Richard Scott represents an important attempt at synthesis.

Scott sees the regulative or 'constraining' aspect of institutional rules as offset by normative rules which 'introduce a prescriptive, evaluative, and obligatory dimension into social life' (Scott, 1995: 32) and by cognitive aspects which 'constitute the nature of reality and the frames through which meaning is made' (Scott, 1995: 40). Normative rules set the parameters of socially appropriate or legitimate conduct, while cognitive elements are constitutive of the social actors and the contexts in which they interact. In both cases, a different approach to individual behaviour is implied from that offered by rational choice theory:

For analysts gathering under the normative pillar, choice is seen to be grounded in a social context and to be oriented by a moral dimension that takes into account one's relations and obligations to others in the situation. A logic of appropriateness replaces, or sets limits on, instrumental behaviour... Cognitive theorists emphasise the extent to which choice is informed and constrained by the ways in which knowledge is constructed... Individuals are not simply constrained but informed and empowered by these preexisting knowledge and rule systems... Broad cultural beliefs as well as individual self-conceptions are the product of social processes. The identities of actors and their interests are viewed as resulting from these processes. Preferences are not taken as given: they are not 'exogenous' to the analysis, but among the most important things to be explained. (Scott, 1995: 51).

These approaches diverge from the orthodox economic approach not just in the scope of inquiry which they open up, but also in their methodological foundations. The 'new institutionalism' in sociology adopts a 'constructivist' ontology in which 'the interests and identities of the principal actors are socially defined and expected to vary across place and time' (Scott, 1995: 137), in contrast to the positivist orientation of mainstream economics, one aspect of which is to see actors' preferences prior to institutional forms. However, in arguing for a potential reconciliation of the two approaches, Scott has suggested that sociological approaches do not displace economic rationality from the picture; rather, they seek to contextualise it in the sense of identifying the social processes through which economic rationality is constructed. What is 'rational' includes certain forms of rule-oriented behaviour, not simply in the sense that rule-bound

behaviour may be based on calculation of the likely pay-offs to individual agents, but more generally in the sense that rules and routines 'reflect subtle lessons of cumulative experience' (March and Olsen, 1989: 22). From this point of view, a number of prior social and institutional conditions must be met before 'economically rational' behaviour may take place. 'The rational choice models apply to only a subset of institutional systems: those that constitute individual social actors as possessing private social interests and the capacity to take action to protect them' (Scott, 1995: 140). It also follows that an understanding of the precise nature of these institutional pre-conditions in particular national and cultural contexts is an important step in understanding the forces behind economic development.

This theme has been taken up by studies of nationally-specific forms of economic governance which use the ideas of the 'business system' or 'industrial order' to explain the 'interpenetration of social institutional structures with aspects of economic organisation' (Lane, 1994:168, 1991; see also Hall, 1984, 1986; Whitley, 1991; Thelen, 1991). This approach stresses the inter-dependence of the separate elements of the institutional framework, namely the state (as regulator and policy-maker), the financial system, the system of industrial relations, the education and training system, and intermediate organisations such as trade unions and industry associations. The inter-dependence of these separate elements creates a 'web of rules' (Lane, 1994:169) which endows the institutional framework with its stability and with a substantial degree of autonomy from short-term social and economic pressures. As a result, institutional change is incremental and partial, and radical innovation is the exception; actors (both individual and collective) have scope for strategic decision-making, but within the framework set by the institutional structures. The principal factors influencing the evolution of organisational and institutional forms are therefore normative, coercive and mimetic in nature, rather than the outcome of a selection process based on competitive forces (Di Maggio and Powell, 1991).

The most systematic attempt to develop an account of legal evolution in the context of social and economic development without denying the distinctive character of legal institutions is the theory of autopoiesis. In common with sociological institutionalism, this denies the positivist basis of mainstream economic theory in favour of a social

constructionist approach, according to which social reality consists of (or is constructed by) communicative systems; social institutions are seen as systems of communications through which meaning and reality are constructed. However, while sociological institutionalism sees organisational systems as essentially open to their environment, thereby 'insisting on the importance of the wider context or environment as it constrains, shapes and penetrates the organisation' (Scott, 1995: xiv), autopoietic approaches see systems as 'operationally closed' in the sense of being self-referential and self-reproducing (Luhmann, 1996; Teubner, 1993).

The legal system is seen as one of a number of autonomous sub-systems within society. Autonomous legal thought is characterised by the development of specifically legal concepts to describe the social environment. Although *social norms* and conventions may operate at levels other than that of law, they have no status within legal discourse except to the extent that they are recognised as legal norms by criteria developed by the legal system itself ('Hartian' secondary rules or rules of recognition: Teubner, 1993: 41). Legal evolution does not consist of the straightforward adaptation of the system to its external environment; rather, 'the most important feature of evolution is the maintenance of the system's internal cyclical structure' (Teubner, 1993: 57). This does not imply, however, that the legal system is *entirely* closed to external influences. Teubner suggests that the legal system 'co-evolves' with other social sub-systems (among which are 'the economy' and 'the industrial relations system'). Each system is 'operationally closed', in the sense that *direct* communication with other systems is impossible, but at the same time 'cognitively open' to its environment (which contains, or perhaps consists of, for this purpose, other sub-systems). This central notion of 'cognitive openness' means that:

law refers to social meanings in a variety of ways, as well as to constructs of reality and social values. In a self-referentially closed legal system, however, these forays into current social values assume the guise of normativisation in its legal form. Their normative content is produced from within the law itself, by constitutive norms which refer back to those values. It is a condition of all forays into current social values that they be subject to legal reformulation. As soon as they are in dispute, a

decision has to be made about them according to criteria established by the law itself (Teubner, 1993: 35).

A number of consequences follow from this analysis. Firstly, the interdependence of law and economy is preserved through the idea of cognitive openness, while at the same time the reductionism of, for example, neoclassical economic theories of law, which see legal evolution as a direct response to external economic influences, is avoided. Secondly, there is a refocusing of attention on legal doctrine as the principal expression of a specifically legal discourse: 'abstract legal thought, dogmatics, and construction as self-descriptions of the legal system have to become central to legal-sociological analyses in such a way that would have appeared impossible in the wake of sociological disillusionment over law' (Teubner, 1993: 44). Legal thought makes use of economic ideas (payment, exchange, transaction, organisation) and translates them back into the legal discourse, but this is not a process through which the law simply comes to reflect a greater social reality, nor do legal mechanisms straightforwardly regulate or reshape this 'reality'. Thirdly, while there is no assumption that law can *directly* influence the economy, any more than the reverse is necessarily true, law and society may come into contact through 'structural coupling', a process consisting of 'perturbation' or 'exogenous shocks' operating upon systems. It is through the combined means of 'interference' and 'interpenetration' between the legal system and its environment that 'social regulation through law [becomes] possible - even if... this takes place in an extremely indirect and rather uncertain way' (Teubner, 1993: 97). This involves the technique of *reflexive law*.

Opportunities for disciplinary synthesis

If sociological institutionalism and social systems theory are quite far removed from the approach taken in mainstream economic theory, they are not so distant from the ground occupied by the new institutional economics. Even then, there are fundamental differences which relate to methodology; the positivism of neoclassical economics and, by extension, of transaction cost economics, is at odds with the 'social constructionism' of economic sociology and the 'constructivist' epistemology of social systems theory. However, these different theoretical categories do not simply address the same subject-matter; in many cases, concepts have been exchanged between these different

disciplinary fields, and concerted attempts at synthesis have been undertaken.²² With regard to the underlying ontological and epistemological issues, a certain amount of fluidity between the different approaches may perhaps be allowed in the attempt to identify a common ground on which disciplinary encounters can take place. We may attempt to sum up the progress made so far.

Firstly, there is a growing common ground to the effect that institutional forms have an *economic* and not simply a sociological significance. This is linked to the Coasian sense of institutions and organisations as mechanisms of coordination.

Secondly, there is also agreement on the need to model economically rational behaviour for *some* purposes. Models employing 'hyperrationality' have been shown to produce interesting results in their analysis, for example, of the circumstances under which longer-term contracts become self-enforcing. Equally, principal-agent models have drawn attention to important features of incentive structures.

Thirdly, it is also abundantly clear that these formal models go only a part of the way to explaining the distinctive characteristics of real-world institutions for contract enforcement. The difficulties facing this research agenda are illustrated by the attempt of theorists to model incomplete contracts. Since this involves the use of concepts such as 'bounded rationality' which appear not to be suitable, by their nature, to representation in formal models, there is some doubt as to how productive this research agenda can be. On the other hand, the acceptance by organisation theory that economic rationality is an important behavioural phenomenon (Scott, 1995), opens up a potentially rich research agenda, which would focus on the *institutional* preconditions of economic activity in various settings.

Fourthly, there is a growing recognition that the distinctive qualities of institutional processes need to be understood in order to throw light on their economic effects. Social systems theory is important here in pointing out the significance of institutional 'self-descriptions' as well as the mediating process which takes place when a system attempts to describe its external environment. The contractual relationship, at a micro level, 'develops its structures by interacting with the "contractual environment" which, however, it constructs itself' (Teubner, 1993:

117). Similarly, the legal-doctrinal system makes its own construction of the subject-matter of regulation, which, while it can be informed by an understanding of economic phenomena, cannot be reduced to or made synonymous with them; the law must 'develop scientifically grounded models of the surrounding systems, and tailor its norms accordingly' (Teubner, 1993: 81). Conversely, attempts to describe institutional forms exclusively in terms derived from economic rationality - as in game theory, or the 'economic imperialism' of Becker or Posner - are simply false generalisations of a logic which would be better understood as the internal language of just one sub-system.

Finally, there is agreement on the need to establish criteria by which to judge the effectiveness of particular organisational arrangements and regulatory interventions. This has both a positive and a normative dimension, in that a deeper understanding of the mechanisms through which economic governance takes place will also aid policy analysis. Economic theory has taken the lead in providing concepts for the evaluation of the welfare consequences of different contractual forms. However, even the new institutional economics offers only a partial account of the role played by the institutional framework at a macro-analytic level: in viewing legal rules in terms of *constraints* on agents' behaviour, it has downplayed the potentially important *channelling* role which is associated with the normative and cognitive dimensions of institutions. There needs to be a better understanding of the variety of ways in which institutional forms influence and interact with the process and practice of contracting.

The Practice of Contracting

We turn now to what we know of the practice of contracting, and consider its implications for the development of an interdisciplinary agenda. Our subject-matter is *contract process*; that is to say, we regard contracts as providing the framework for a complex set of interactions between the parties to economic relationships. Although this analysis can be applied to relations within organisations, in the present context we focus on the distinctive issues of economic organisation and regulation which are raised by inter-organisational relations.²³

The private sector: networks, hybrids and trust

Under the influence of Stewart Macaulay (1963; 1985), the predominant view of socio-legal scholars has been that contractual process in business relationships has relatively little connection with contract law, or at least with the traditional or 'classical' law of contract. Macaulay's empirical studies have been seen as confirming Durkheim's observations on the importance of the *non-contractual* elements of business relationships, including loyalty, cooperation and trust.²⁴ The resulting debate on the meaning and significance of trust has intersected with the growing interest in networks and hybrids as distinctive governance structures. Trust is widely seen as the basis for an expectation of, or confidence in, future performance, whose presence is capable of promoting cooperation and thereby reducing transaction costs in network-type relationships which are based on long-term or repeated exchange between organisations. The role of contract law in these relationships is thought to be minimal, since legal sanctions for non-performance are seen as too blunt to be of much use in promoting cooperation based on flexibility and give and take; equally, formal contractual documents, which lay down the parties' future obligations, cannot by their nature capture the parties' open-ended commitment to the success of the venture on which cooperation is built (see, in particular, Sako, 1992; Campbell and Harris, 1993).

Bruce Lyons and Judith Mehta (1997a, 1997b) have built on Macaulay's work by analysing trust from the point of view of two versions of the concept, one derived from economic reasoning, which they refer to as 'self-interested trust' (SIT), and the other from sociological perspectives, which they term 'socially-oriented trust' (SOT). The economic conception sees trust as derived from agents' calculations of future pay-offs from cooperation, while the sociological one is based on shared cultural or communal values, a history of successful trading between the parties and inter-personal ties. They suggest that contract formality may be important in the context of self-interested trust, but that it may undermine socially-orientated trust, by introducing an element of adversarialism and a separation of interests. They also examine the extent to which observations of contract forms correlate with Williamson's predictions concerning the incidence of classical, neoclassical and relational contract types. Their empirical study, based on a close analysis of buyer-supplier relationships in a

sample of manufacturing firms, is in line with the transaction-cost approach, suggesting that managers act in a discriminating fashion when determining the form of inter-firm cooperation: neoclassical and, then, relational contracting emerge as the frequency of contracting and idiosyncratic investments grow in importance.

Lyons and Mehta argue that the distinction between SIT and SOT is the missing link in Williamson's contracting schema. With SIT, based on calculativeness, it is only the possibility of future trading which keeps the parties from defecting in the absence of contractual safeguards. With SOT, by contrast, behavioural risk is less of a threat and more of an *opportunity* for trust to develop; moreover, such trust grows with use and can be actively fostered by the parties, through gift-exchange of various kinds and other means of investing in social relations. The authors' empirical study suggests that the greater the risk of opportunism, the more firms are prepared to invest in trust building of this kind. Also important are preferred supplier policies and quasi-vertical integration, or types of network relationship in which the customer has a significant ownership stake in the productive assets (such as machines or tools); these can be seen as devices for establishing effective incentive structures, in the manner of SIT. Self-interested and socially-orientated dimensions of trust may be found together in the same trading relationship. Formal documentation often accompanies long-term trading relationships, and although resort to law is unusual in such a context, various extra-legal sanctions may be available to guard against opportunism. In general, formal agreements and legal sanctions are much less important than the 'text between the lines', or the perceptions of managers as to what is needed to foster and maintain a trusting relationship. The presence or absence of trust vitally affects the interpretations given to the written text.

Peter Buckley and Malcolm Chapman (1997a, 1997b) have also taken an interdisciplinary approach in their recent work on the foundations of transaction cost economics, which focuses on the social construction of transaction costs. Their premise is that ideas from social anthropology can be used to cast light on the central issues addressed by transaction cost economics, in terms of the boundaries of firms and the use of contracts to manage risk. Economic behaviour of the kind which is modelled using the formal techniques of game theory and principal-agent theory takes place, they suggest, within a pre-existing 'social

fabric' of common meanings and shared perceptions which are built up through language, social interaction and organisational histories. It is necessary to study the processes by which managers discover and compute market prices and the costs of external contracting when taking the 'make or buy' decision; these decisions find expression in language, rather than in precise calculations. Managers' use of the terms 'transaction', 'company' and 'core business' indicate the wide variety of meanings which are, in practice, imputed to these concepts.

The central finding of this and related studies by the authors is that decisions on internalisation are taken on the basis of managers' subjective perceptions of transaction costs rather than on an objectively verifiable set of calculations. As a result, the boundaries of the firm are set by the maxim that *perceived* transaction costs are always minimised. This does not mean that decisions are taken irrationally, or without the benefit of evidence and assessment; it does mean that socially constructed perceptions play an important role in supplementing the agents' bounded rationality. A focus on the *discourse* of transaction costs would, it is suggested, open up a rich research agenda into the nature of business decision making.

The research of Dan Coffee, Peter Nolan, Richard Saundrey and Malcolm Sawyer (1997) throws light on the impact upon contractual relations of regulatory change resulting from the government-led restructuring of the British television industry in the 1980s and 1990s. Competition was introduced into the sector through legislative change, in response to the view that the large, vertically-integrated broadcasting organisations were inefficient monopolies. Changes took the form of a requirement that both the state-owned British Broadcasting Corporation (the BBC) and the private-sector ITV companies should take up to 25% of their programmes from independent producers, and the introduction of a new auction process for the ITV franchises under which the company which bid highest would win subject only to the need to pass a 'quality threshold'. The license-fee to the BBC was linked to inflation, and within the BBC an internal market was put in place (the 'producer choice' system), with the organisation divided into business units which contracted one with another for the purchasing and supply of facilities and services. The economic theory underlying these changes was not made clear; in particular, although it was claimed that greater efficiency and choice for the consumer would result, no account was taken of the transaction-cost benefits of vertical integration.

Coffee *et al.* find that neither the BBC nor the ITV companies have perceived the 25% quota as leading to an improvement in the quality of programmes, nor to a reduction in their cost, although there has been an increase in flexibility. This is consistent with what a transaction-cost framework of analysis might have been predicted. The effects of the new franchise auction system for the ITV companies and producer choice for the BBC were, in each case, to put pressure on organisations to cut costs through labour shedding, and while productivity has improved, this is seen as principally due to changes in technology rather than in the form in which the industry is organised. Training has also been adversely affected as a result of pressures on costs and the breaking-up of the larger broadcasting organisations (see Saundry, Nolan and Sawyer, 1998). The chapter suggests, then, that a regulatory 'shock' of this kind may have unpredictable effects on the contract process. Moreover, the expected benefits of competition, in terms of enhanced performance and market-led learning, cannot be achieved simply by the act of legislating a market into existence.

The work of Simon Deakin, Christel Lane and Frank Wilkinson (1997) is based on a comparative study of supplier relations in engineering which was designed to evaluate the impact on contract form of different legal, institutional and sectoral conditions. The three countries chosen for study (Germany, Britain and Italy) exhibited important differences at the level of the institutional framework governing inter-firm relations which were reflected, in turn, in the forms of contractual agreements. In Germany, the research found that the legal system created incentives of various kinds for firms to enter into long-term trading relationships which were often formalised through long-term contracts, whereas in Britain and Italy there was less stress on contract formality and a greater emphasis on, respectively, a pragmatic attitude of 'give and take', and tacit understandings concerning fair dealing and adherence to quality. Across the three countries, evidence on the growth of specialised forms of inter-firm dealing was mixed, with only a minority of firms reporting sustained 'partnership' relations with commercial customers or suppliers. This was despite the general growth of competition in product markets and the resulting stress on customisation, just in time delivery and the ability of suppliers to compete both on price and quality. It would seem that enhanced competition does not necessarily lead to improvements in quality, nor to closer forms of cooperation.

This study has a number of general implications for the socio-legal understanding of contract. Firstly, the institutional environment is seen to be an important determinant of contract form. Legal and institutional forms can encourage, or discourage, particular forms of contracting, and strategies which are feasible for firms in one institutional setting may be uncongenial in others, independently of both market structure and of the 'underlying' features of transactions in terms of asset specificity and frequency. Secondly, in certain contexts contract may perform an important *trust-building* function. There is no *necessary* opposition between trust and contract formality. The role of contract law in such cases is not so much to supply an immediate sanction which will fully compensate the victim of breach for the loss of cooperation, but rather to help sustain an environment in which a norm of trustworthy behaviour becomes established. Rules and principles contained in quality standards and notions of good faith can have an important normative and cognitive role in building expectations of goodwill trust. Thirdly, institutional forms are an important mechanism for the reproduction of trust. Here, it is the effectiveness of the *interactions* between the different elements - the system of contract law, industry-level agreements, quality standards and tacit assumptions concerning ethical behaviour in business - which determine whether the contractual environment is supportive of inter-firm cooperation.

The public sector: quasi-markets and the new public management

Similar competitive forces to those which have been reshaping the private sector have affected the public sector too, but with a number of essential differences. Firstly, the quasi-markets which operate within education and health operate on the basis of a complex set of regulations whose aim, broadly speaking, is to 'mimic' what is taken to be a private sector market. The presence of the state as regulator and as final guarantor of the supply of services means that these internal markets operate in ways which are distinct from their private-sector counterparts. Secondly, certain features of private markets are lacking in quasi-markets, in particular the discipline of company failure. Whereas, in the private sector, many of the beneficial effects of competition are said to derive from the ability of the forces of competition to drive inefficient firms out of business and for the assets to be reallocated through the procedures of bankruptcy and insolvency,

this is not normally an option which applies to the public sector. While there are, for example, mechanisms for the reorganisation of failed trusts, these are largely confined to the replacement of an ineffective management (and, to that extent, parallel to a certain degree the private-sector discipline of hostile takeovers). A third significant difference relates to the nature of the contracts made between separate entities in quasi-markets. Under the National Health Service and Community Care Act 1990, agreements between purchasers and providers within the NHS internal market are not legally binding as contracts; nor are agreements between business units within the BBC. In the case of the external sourcing of goods and services in local government and the NHS, a variety of arrangements may be observed depending on whether the supplier is the council's own direct labour organisation (in which case a non-legally binding contract is agreed) or a private-sector company (in which case the agreement will be legally enforceable). Here, then, we observe a complex variety of different legal and contractual arrangements, which may be thrown into competition with each other as they are under the terms of legislation requiring local government authorities to conduct a process of compulsory competitive tendering (CCT).

Peter Vincent Jones (1997) has developed a distinctive analytical framework for the analysis of CCT in local government, drawing on aspects of transaction cost economics as well as the quasi-markets literature. In common with other researchers in the socio-legal tradition, he takes a broad view of contracting, in terms of a process of managing and adjusting relationships within a framework set by formal agreements and other external regulatory influences. Although the legislation governing CCT is highly prescriptive and rigidly controls the freedom of action of local authorities, a number of separate hybrid forms have nevertheless emerged. Firstly, there is the contracting-out of services to external, private-sector suppliers, which still accounts for a small but increasing proportion of services affected by CCT. Secondly, the authority may 'contract-in' by establishing a relationship with an internal service provider, if its own direct labour organisation (DLO) wins the tender under the strict rules laid down by the legislation. Here, a variety of forms are observed in practice, involving differing degrees of integration and control and resulting in distinct types of 'hard' and 'soft' quasi-market relations. Thirdly, local authorities may themselves set up or otherwise take an interest in companies which operate to

supply services to a number of purchasers in the public and (conceivably) the private sector. Here, hierarchical relations may persist along with elements of shared institutional values as well as inter-personal trust, but as the organisations concerned achieve a greater degree of autonomy, they increasingly resemble normal commercial entities, and close relations may give way to arms-length dealings.

The case-study evidence assembled by Vincent Jones demonstrates that contractual failure, in terms of a breakdown of cooperation, is likely to arise in circumstances where neither institutional nor inter-personal trust can be sustained; in particular, it points to the valuable role which hierarchical relations can play in fostering and maintaining contractual standards. A richer and more varied picture of CCT is thereby provided. A close examination of contract process reveals tensions and inefficient outcomes which are linked to the regulatory environment established for CCT, and in particular the element of compulsion. However, Vincent-Jones rejects calls for increased legal intervention as the solution to contracting problems. In particular, his analysis questions claims that superior results could be achieved through more intensive judicial review of the contracting process. On the contrary, if the aim is to capture the benefits of efficient contracting, local authorities and their suppliers need to have the discretion to develop solutions which are appropriate for local needs, with tendering being used on a voluntary as opposed to a compulsory basis.

The work of Jonathan Montgomery (1997) analyses the nature of the NHS internal market. He argues that within the internal market, mechanisms based on contract and competition have operated alongside new forms of public-sector management and centralised planning. While the internal market is a mechanism within the NHS, the NHS retains many of the features of a bureaucratically-organised public service. For example, NHS purchasers continue to have statutory obligations to provide health care services, and national policy imperatives, rather than market incentives, are the main driving force in policy changes. Central management, in the form of the National Health Service Executive (NHSE), plays a pivotal role not just in maintaining the conditions for effective competition, but also in setting out national health care priorities and ensuring the observance of quality standards. Although the new marketised system allows, in principle, for more effective reallocation of resources within the NHS,

geographical and other restrictions on the ability of purchasers to switch contracts from between providers place restraints on the effectiveness of these market mechanisms. The institutional character of the internal market also affects the contracting process at various points. In particular, the legal framework encourages annual renegotiation of contracts and thereby builds in an element of short-termism. In short, the market has been constructed as a means to various ends which are set not by ultimate consumers of health care services, but by the central planners; it is an open question whether contract and, still more, competition are necessary or adequate means to the achievement of these ends.

The work of Jean McHale, David Hughes and Lesley Griffiths (1997) examines the unusual and distinctive mechanisms for dispute resolution which have grown up within the NHS internal market. The National Health Service and Community Care Act 1990 decreed that 'NHS contracts' between purchasers and providers were not to be legally enforceable as contracts by the regular courts; instead, a specialised procedure was set up, involving reference of disputes to the Secretary of State. In practice the power is exercised by nominees who are themselves internal NHS managers or officials; the process is kept within the NHS. The central NHS management, in the form of the NHSE or (in the study in question) the Welsh Office, plays a major role in general contract management. It may take steps to resolve pre-contractual disputes, to encourage parties to reach agreement and to settle disputes informally where possible. All these are features which are much more characteristic of hierarchical or intra-organisational relationships, than of market-based transactions.

As McHale *et al.* note, many private sector markets are characterised by a high degree of regulation and by significant switching costs which may inhibit the workings of competitive mechanisms; equally, the role of legal enforcement in private-sector contracting is often limited by comparison with that of extra-legal sanctions. One key difference, however, between private-sector markets and the internal market is that the latter is both regulated and *imposed*; central direction, as Montgomery also shows, is the principal mechanism for policy and structural change. This places limits on the capacity of the NHS market to generate solution to contracting problems through an internal evolutionary process (see also Hughes, McHale and Griffiths, 1997).

The complexity and distinctiveness of the NHS market make it difficult to define, for analytical purposes, the essential features of its 'hybrid' form. This inevitably poses the issue of whether the internal market is sufficiently durable, but also adaptable, to survive in something like its present form.

Richard Laughlin and Jane Broadbent (1997) have critically examined recent legislation through which quasi-markets were introduced into the public sector provision of health and education services. They develop a model of legislation which draws on theories of autopoiesis. The legislation which has been responsible for the reorganisation of the public sector in Britain is an instance of juridification in the sense of excessive and ineffective regulation, which fails to produce a successful 'structural coupling' of regulatory mechanisms with the social sub-systems which are being regulated. Specifically, the attempt to introduce 'economistic' modes of reasoning and 'accounting logic' into the workings of the public sector, contrary to the long-standing culture and ethos of the public service, has either led to the disintegration of distinctive systems of organisation which had operated in the public sector, or, at best, to excessively high absorption and adaptation costs.

It is perhaps paradoxical that the limits of legal regulation should be so clearly demonstrated by attempts to use legislation to achieve its supposed opposite, namely the institution of a market which can operate on the basis of decentralised exchange. Here, as elsewhere, the creation a market *de novo* proves to be an immensely complicated task; nor can we regard the resulting institutional arrangements as in any sense self-regulating. From this, we do not necessarily conclude that the attempt to introduce market forces into the public sector is bound to fail. However, for this policy to succeed, more attention needs to be paid to the preconditions for more effective 'structural coupling', including the use of reflexive law techniques.

The economics of contract law

The economic analysis of law, despite the enormous volume of material which it has produced over the past three decades or so, has remained firmly wedded to a form of price theory which has surprisingly little connection with the wider agenda for research into organisations and institutions which Coase's writings have inspired. Even game theory

has been taken on board only comparatively recently. The idea that a new form of law and economics is needed, which is less doctrinaire and less narrowly focused on the properties of perfectly competitive markets, is slowly taking hold.

Roger Brownsword's analysis of the notion of good faith in the English law of contract (1997) finds that, notwithstanding the absence of a general principle, English law contains *in certain contexts* ideas which are equivalent to concepts which are found in civil law systems. This work also shows how the concept of good faith is linked to an important distinction between what Brownsword has termed 'static' and 'dynamic' market individualism. The former identifies contract with a narrowly adversarial form of bargaining and purports to limit legal intervention to the protection of interests which have been clearly bargained for. The latter qualifies narrow self-interest by reference to communal norms of fair trading, and to the 'reasonable expectations' of commercial parties. It is argued that as the dynamic model develops, it can enable the law to play a role in fostering cooperative economic relationships.

Critics of this view might reply that there is nothing in the dynamic market model which could not be achieved under the more traditional or 'static' analysis, since the latter provides a framework within which the parties can adequately fashion their own agreement (McKendrick, 1995). One response to this might be to argue that the provision of more efficient 'default rules' would produce a saving on transaction costs; as commercial relationships move more in the direction of long-term, complex contracting, society is better-off with a general doctrine of good faith than without it. This would be a good answer using well-established techniques in the economic analysis of law. However, Brownsword points to a more broad-ranging argument, which is that standards based on full disclosure, fair dealing and prompt payment have a channeling effect which privileges certain, cooperative strategies over others. In a world where cooperation is provided with institutional support in this way, the capacity of the parties to deal with radical uncertainty is enhanced to the point where risk-management, which would otherwise have been too costly, becomes possible. Moreover, legal support for standards is important in generalising good practice, penalising free riders and limiting the danger posed by 'destructive' competition based on undercutting.

Hugh Collins (1997) has analysed the growing use of quality assurance in 'supplier partnerships' in manufacturing industry. He notes that at first sight, it is difficult to see why supplier partnerships should be regarded as a superior alternative to hierarchy, on the one hand, or arms-length dealing, on the other, since they seem to combine the costs of repeated trading with a degree of supervision and control. However, this neglects the importance of self-monitoring by the supplier, and the savings on search costs which arise from the establishment of a successful long-term trading relationship. In addition, firms involved in supplier partnerships build trust on the basis of their willingness to be open to the scrutiny involved in external certification of their procedures and processes. These trust-building strategies are encouraged by those national and international standards which set benchmarks for quality assurance and for the conformity of products with technical and health and safety requirements.

This form of cooperation raises a number of legal issues. In particular, the still-prevalent assumption of the English law of contract, that contracting parties deal strictly at arms length, is inappropriate. The development of a legal model which recognises the distinctive economic characteristics of inter-firm cooperation is needed. This is likely to take the form of a more sophisticated approach to the implication of terms, by way of recognition of the implicit understandings which often characterise long-term relationships. The sharing of risks and information between the contracting parties also makes it necessary to consider the possibility of treating such hybrids as single legal entities for the purposes of certain liability claims.

The work of David Campbell (1997) demonstrates that a more productive conception of transaction cost economics can be arrived at by placing at its core an understanding of the social preconditions of contractual activity. In this way we may avoid a situation in which socio-legal scholarship rejects economic analysis completely; failure to engage with economic analysis is tantamount to vacating the field to the economic imperialists.

Campbell points out the important links which exist between relational contract theory and transaction cost economics, and points the way to a research agenda which has always been implicit in transaction cost

theory but which has been unduly neglected. He stresses the importance of Arrow's writings on transaction costs, which demonstrate not just an awareness of the role played by institutional factors in determining the allocation of resources, but also an appreciation of the appropriate limits to the role of economic analysis. The achievement of the Arrow-Debreu theorem in bringing the supply of future goods into the analysis of competitive equilibrium highlights the limitations which are inherent in that model since, plainly, *all* the contingent markets necessary to bring about an optimal allocation can never be brought into existence, even if there is a certain extension of futures trading as a consequence, for example, of new technology. Arrow himself has set out the research agenda which is needed to examine the necessary social and institutional conditions for complex contracting to take place under conditions of less than perfect competition. In Campbell's view, this must involve an acceptance that economic action is embedded in social relations, and necessarily leads to the position that both cooperation and competition have an ontologically prior basis in the practices and norms which constitute markets and which provide the framework for organisations. From a normative point of view, then, there should be no *a priori* assumption that solutions based on market governance are to be preferred to those based on collective provision.

Competition policy

We finally turn to the tensions which exist within competition policy, in particular with regard to the treatment of longer-term, cooperative relations between firms. Simon Deakin, Tom Goodwin and Alan Hughes (1997) show that competition policy has had to accommodate a number of different economic and non-economic goals. In the United States, the treatment of antitrust legislation has shifted away from a concern with the abuse of monopoly power towards a more clearly-focused efficiency-based analysis, mainly under the influence of the Chicago school of law and economics. The *Sylvania* case of the mid-1970s represents what, for the time being at least, is the high water mark of judicial acceptance of economic reasoning in cases involving vertical contracts. However, developments since then illustrate the complexities which are inevitably involved in introducing economic ideas in legal discourse. The use of rival economic theories, mainly in the form of game theory and transaction cost economics, has increased, and with this has come greater uncertainty as the impact of the courts'

rulings. There has as yet been little or no successful transplantation of the ideas of game theory, in particular, into the law; the insights of this body of work remain largely at the level of formal analysis.

The United Kingdom and the European Community illustrate two contrasting cases. The UK has retained a predominantly form-based approach, under which the form of agreements largely determines whether and how they are scrutinised. A complex, court-led jurisprudence of the kind observed in the US has not developed, largely because of the heavy element of administrative and political discretion within the system. In the EC, the establishment of the common market, rather than economic efficiency as such, has been the goal of legislation dealing with vertical restraints. However, the more recent legal instruments in this area represent important attempts to balance the pro- and anti-efficiency aspects of vertical contracting.

This last theme is taken up in the research of Alan Gutterman (1997), who has undertaken a comparison of the EC Technology Transfer Regulation with the US antitrust rules governing patent licensing. Gutterman notes that intellectual property law has always existed in a state of tension with antitrust and competition law, because of concerns that patent rights represent a form of monopoly. However, the economic basis for this argument is weak, since patents only represent a danger to principles of competition law if they are used by firms to suppress competition from other products or to cartelise product markets. Patent licensing, which is an important aspect of many franchise and joint venture agreements, is an important case here, since it combines the use of intellectual property rights with long-term agreements between firms. Here, the potential gains from collaboration in terms of enhanced innovation have to be weighed against the possibility that long-term agreements will reduce intra-brand competition as well as deterring entry by potential competitors.

One technique which regulators have developed in addressing this difficult balancing act is the use of 'safety zones' (in the US) or guidelines contained in block exemptions (in the EC) in an attempt to provide firms with some guarantee that cooperative arrangements will not be opened up as a matter of course to costly and expensive scrutiny. Similarly, in the United States the National Cooperation in Production and Research Act has been passed in order to encourage joint ventures

which would otherwise have been threatened by antitrust intervention. Here, the law recognises both the economic benefits which flow from inter-firm cooperation, and also the inherent limits to the policy of promoting competition.

The idea that competition is primarily a means to a greater end, which is the goal of enhanced *competitiveness*, is also addressed in recent work in this field. Deakin, Goodwin and Hughes discuss the use within law and policy of notions of *dynamic efficiency* as an alternative to the more traditional static efficiency. Dynamic efficiency refers, in this context, to the capacity of a productive system to innovate and adapt to changing external circumstances. Like 'competitiveness', dynamic efficiency is an idea which many mainstream economists regard with scepticism, in part because of difficulties in defining and modelling it. However, the central issue for lawyers and policy-makers is whether these ideas can form an adequate conceptual basis for government interventions which go 'beyond competition policy', in the sense of taking steps to create the kind of supportive environment within which inter-firm cooperation can most effectively develop. It is highly relevant, in this context, that the strengthening of industrial 'competitiveness' is now listed in the EC Treaty as one of the principal goals of the European Community.

In his work, Steve Anderman (1997) examines the notion of competitiveness in the context of EC law governing mergers and joint ventures. The early years of the Community's competition policy were characterised by a concern to take steps to eliminate agreements which resulted in the partitioning of markets along national lines. However, as the common market has developed, attention has increasingly turned to the issue of external competition, in particular in areas of high technology industry. The economic concept of dynamic efficiency provides a basis on which the goals of competition and competitiveness may be reconciled, and this has found expression to some extent in the legal notion of 'potential competition' as a basis for evaluating complaints of anti-competitive behaviour. However, much depends on how competition policy rules are enforced by the Commission, and a completely consistent approach has not yet emerged. Procedures under the Merger Control Regulation have arguably struck a more successful balance than those taken under the general terms of Article 85 of the Treaty, which have been used for appraising new technology joint

ventures. Moreover, the Commission has made only a limited recognition of industrial policy aims, such as the building of intra-Community 'champions' to compete with external competition, when applying the principle of abuse of a dominant position under Article 86.

Conclusion

The effectiveness of inter-organisational cooperation is a vital aspect of the reforms to the public sector, as it is to economic competitiveness in a wide sense. A focus on contract process reveals complex patterns of interaction between individual agreements, social norms and the general framework of contract law and competition policy. To make further progress in this area, interdisciplinary work will be essential. Modern institutional economics holds out the prospect of an analytical framework within which different organisational forms, and different types of institutional regulation, can be compared for their effects in terms of economic efficiency. However, this is not a task which economics can achieve alone. If the promise of a new interdisciplinary field is to be realised, there must be a reciprocal exchange of ideas and concepts. A 'bridge' subject must be capable of taking traffic from both directions.

In this context, it is legitimate to ask whether 'new institutional economics' is, in its current state, sufficiently open to the influences and, in particular, the methodologies, of other disciplines and approaches (see Pratten, 1997). Oliver Williamson, while acknowledging antecedents of his own work in that of Commons, has also been careful to distinguish NIE from the tradition of 'older institutionalism' which, according to received wisdom, faded away because it failed to provide a tractable theory of institutional form. Transaction cost economics, by contrast, is claimed to provide an effective basis for 'operationalising' concepts and formulating hypotheses which can be tested using econometric and related techniques.²⁵ Its capacity for formalisation and for prediction mark it out from sociological approaches (Williamson, 1993b). It is for reasons related to the formal rigour of NIE that Williamson has been reluctant to incorporate within his analysis the notions of trust and power which, he argues, have not been adequately operationalised (on power, see Williamson, 1989; on trust, 1993a).

However, this view has become more difficult to sustain in the light of advances in sociological institutionalism and, in particular, in social systems theory. These suggest that a more systematic and comprehensive framework for analysing insitutional forms is possible. In particular, theories of autopoiesis suggest ways in which greater precision can be brought to the key task of analysing evolutionary processes. At the same time, these bodies of work open up new opportunities for a range of research methodologies; their orientation is pluralistic and tolerant of different points of view, in contrast to the narrowing focus of 'economic imperialism'. Case-study work, institutional histories and the analysis of legal-doctrinal concepts can all be seen to have a part in contributing to a deeper understanding of economic form and behaviour.

The separate disciplinary approaches nevertheless remain distinct. This must be so, in the light of their differing ontological and epistemological starting-points. Indeed, the contrast between the predominantly positivist approach of economics and the constructivist epistemology adopted in economic sociology and the sociology of law may pose a significant barrier to an integration of the different approaches. However, the challenge here does not necessarily lie in the elaboration of a single set of methodological principles, around which the social sciences can unite. It may be more productive, at least in the short to medium term, to see the task in terms of constructing a common language through which various dialogues between the *separate* disciplines can take place. As long as this work is informed by a broadly-defined methodological pluralism, it should be capable of producing insights which will be of general interest. It may also contribute to the longer-term project of reassessing the methodological foundations of the social sciences, which is currently underway but is still in the process of developing.

The work carried out under the ESRC's Contracts and Competition Programme and related initiatives indicates that a substantial research agenda based on an interdisciplinary approach not only already exists, but that interdisciplinary work has already made significant advances in our understanding of contract process. The implications for policy are perhaps less clear. Nevertheless, it may be appropriate to reflect not just on some of the effects of deregulation, marketisation and the intensification of competition, but also on the role played by economic

ideas in public policy-making. It may be argued that many of the reforms of the past ten to fifteen years were introduced in ignorance of developments in economic theory which are revising our notions of how markets and organisations work. In the rush to the market, governance issues played almost no role in the selection of the institutional framework. In the next round of regulatory reforms, that is unlikely to be the case.

Notes

1. This approach is associated above all with the work of Becker (1976) and Posner (1994).
2. Jonathan Michie was Director of the Contracts and Competition Programme, and Simon Deakin was a project leader.
3. An 'externality' is, for this purpose, an 'external' cost or benefit which is imposed, or conferred, on one economic agent by another, independently of an exchange. In the zero transaction cost world, by definition, all such effects can be anticipated and transacted for (see Dahlman, 1979).
4. A 'social cost', in this sense, refers to the residue of inefficiency in the system which results from the presence of externalities. In the zero transaction cost world, with perfect contracting, this residue disappears.
5. Coase, 1996: 106, describes as 'misleading' A.W.B. Simpson's comment (see Simpson, 1996:58) to the effect that Coase's first idea is 'deep skepticism as to the desirability of government intervention'.
6. 'Another consequence of the assumption of zero transaction cost, not usually noticed, is that, when there are no costs of making transactions, there are no costs to speeding them up, so that eternity can be experienced in a split second' (Coase, 1988: 15).
7. For accounts of the basic theory and surveys of the literature, see Pratt and Zeckhauser, 1985; Stiglitz, 1990; Milgrom and Roberts, 1992, in particular Parts III and IV.
8. It is also important in the context of post-Coasian, neoclassical accounts of the theory of the firm (see Alchian and Demsetz, 1970; Jensen and Meckling, 1976).
9. For surveys, see Rosen, 1985; Azariadis, 1990; Milgrom and

Roberts, 1992: Part V.

10. See Perrow, 1986.
11. See in particular Hart, 1990, 1995.
12. This issue has gained particular prominence in the context of the theory of the firm as a 'nexus of contracts': see Cornell and Shapiro, 1987; Shleifer and Summers, 1988, and Jensen, 1993.
13. For philosophical and methodological analyses of the prisoners' dilemma, see Elster, 1986.
14. More precisely, because it is rational for each party to defect in the final round (after which no retaliation is possible), it is also rational for each party to anticipate this outcome by defecting in the *penultimate* round, and in the round before that, and so on.
15. On the role of reputation see Kreps, 1990, and Coleman, 1990; on private ordering see Williamson, 1983, and Kronman, 1985.
16. Milgrom and Roberts, 1992: 269: reputation enhanced by institutions; Kotowitz, 1990: 212: 'government policies which enhance complete contracts and improve their enforcement, can be welfare enhancing. Examples are contract law, liability rules, and trade regulations'.
17. Levine, 1991, and Levine and Parkin, 1995, make this argument in the context of employment contracts.
18. This is accepted by both the critics (Hodgson, 1988; Ramstad, 1995) and proponents (Williamson, 1996: 3) of NIE.
19. See e.g. Marschak, 1990: 229, complaining that Williamson (1975) 'teems with terms, concepts and conjectures that the formal theorist must struggle mightily to make precise'.
20. See Powell, 1990.

21. See generally Hodgson, 1993, for discussion and analysis of evolutionary thought in economics, in particular that of Hayek.
22. In particular: Williamson, 1996; Scott, 1995; Teubner, 1993: ch. 7.
23. The growing body of work in industrial relations and labour economics that is concerned with the analysis of trust at the level of the contract of employment raises distinctive issues of its own which, for reasons of space, we do not address here, although we recognise the links which exist between inter- and intra-organisational analyses. For work on the employment relationship which develops these links, see Saundry, Nolan and Sawyer, 1997.
24. In his classic 1963 study, Macaulay makes only a passing reference to trust, but the association between trust and the non-contractual elements of business relations has since been extensively taken up. See Beale and Dugdale, 1975; Hodgson, 1988; Sako, 1992; Campbell and Harris, 1993; Sako and Helper, 1996.
25. The vast majority of empirical 'tests' of transaction-cost theory employ econometric, rather than case-study techniques; see the survey by Klein and Shelanski, 1995.

References

- Alchian, A., and Demsetz, H. (1972) 'Production, Information Costs, and Economic Organisation.' *American Economic Review*, 62: 777-95.
- Alt, J. and Schepsle, K. (eds.) (1990) *Perspectives on Positive Political Economy* (Cambridge: Cambridge University Press).
- Aghion, P. and Hermalin, B. (1990) 'Legal Restrictions on Private Contract can Enhance Efficiency.' *Journal of Law, Economics and Organisation*, 6: 381-409.
- Anderman, S. (1997) 'Commercial Cooperation, International Competitiveness, and EC Competition Policy.' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Auerbach, A. (ed.) (1988) *Corporate Takeovers: Causes and Consequences* (Chicago: University of Chicago Press).
- Ayres, I. and Gertner, R. (1992) 'Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules.' *Yale Law Journal*, 101: 729-773.
- Azariadis, C. (1990) 'Implicit Contracts.' In Eatwell, J., Milgate, M. and Newman, P. (eds.) *Allocation, Information and Markets* (London: Macmillan).
- Beale, H. and Dugdale, T. (1975) 'Contracts between Businessmen: Planning and the Use of Contractual Remedies.' *British Journal of Law and Society*, 2: 45-60.
- Becker, G. (1976) *The Economic Approach to Human Behaviour* (Chicago: University of Chicago Press).
- Bishop, W. (1983) 'The Contract-Tort Boundary and the Economics of Insurance' *Journal of Legal Studies*, 12: 241-266.

- Bornstein, S., Held, D. and Krieger, J. (eds.) (1984) *The State in Capitalist Society* (London: Unwin Hyman).
- Broadbent, J. and Laughlin, R. (1997a) 'Contracts and Competition? A Reflection on the Nature and Effects of Recent Legislation on Modes of Control in Schools.' *Cambridge Journal of Economics*, 21: 277-290.
- Broadbent, J. and Laughlin, R. (1997b) 'Contracts, Competition and Accounting in Health and Education: An Example of Juridification at Work?' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Brownsword, R. (1997) 'Contract Law, Cooperation and Good Faith: The Movement from Static to Dynamic Market Individualism.' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Buckley, P. and Chapman, M. (1997a) 'The Perception and Measurement of Transaction Costs.' *Cambridge Journal of Economics*, 21: 127-145.
- Buckley, P. and Chapman, M. (1997b) 'A Longitudinal Study of the Management of Cooperative Relations.' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming)
- Coase, R.H. (1937) 'The Nature of the Firm.' *Economica* (NS), 4: 386-405.
- Coase, R.H. (1960) 'The Problem of Social Cost.' *Journal of Law and Economics*, 3: 1-44.

- Coase, R.H. (1988) *The Firm, the Market and the Law* (Chicago: University of Chicago Press).
- Coase, R.H. (1996) 'Law, Economics, and A.W. Brian Simpson' *Journal of Legal Studies*, 25: 103-119.
- Campbell, D. (1996) 'The Relational Constitution of the Discrete Contract.' In Campbell, D. and Vincent-Jones, P. (eds.) *Contract and Economic Organisation: Socio-Legal Initiatives* (Aldershot: Dartmouth).
- Campbell, D. (1997) 'The Relational Constitution of Contract and the Limits of "Economics": Kenneth Arrow on the Social Background of Markets.' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Campbell, D. and Harris, D. (1993) 'Flexibility in Long-term Contractual Relationships: The Role of Cooperation.' *Journal of Law and Society*, 20: 166-191.
- Coffee, D., Nolan, P., Saundry, R. and Sawyer, M. (1997) 'Regulatory Change in the British Television Industry: Effects on Productivity and Competition.' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Coleman, J. (1990) *Foundations of Social Theory*. Cambridge, Mass: Harvard University Press.
- Collins, H. (1997) 'Quality Assurance in Subcontracting.' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Cornell, B. and Shapiro, A. (1987) 'Corporate Stakeholders and Corporate Finance.' *Financial Management*, 16: 5-14.

- Dahlman, C. (1979) 'The Problem of Externality' *Journal of Law and Economics* 22: 141-162.
- Deakin, S. and Michie, J. (eds.) (1997) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Deakin, S. and Wilkinson, F. (1996) 'Contracts, Cooperation and Trust: The Role of the Institutional Framework.' In Campbell, D. and Vincent-Jones, P. (eds.) *Contract and Economic Organisation: Socio-Legal Initiatives* (Aldershot: Dartmouth).
- Deakin, S., Goodwin, T. and Hughes, A. (1997) 'Cooperation and Trust in Inter-Firm Relations: Beyond Competition Policy?' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Deakin, S., Lane, C. and Wilkinson, F. (1997) 'Contract Law, Trust Relations, and Incentives for Cooperation: A Comparative Study.' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Di Maggio, P. and Powell, W. (1991) 'Introduction.' In Powell, W. and Di Maggio, P. (eds.) *The New Institutionalism in Organizational Analysis* (Chicago: University of Chicago Press).
- Elster, J. (ed.) (1986) *Rational Choice* (Oxford: Blackwell).
- Gillette, C. (1990) 'Commercial Relationships and the Selection of Default Rules for Remote Risks.' *Journal of Legal Studies*, 19: 535-581.
- Grossman, S. and Hart, O. (1986) 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration.' *Journal of Political Economy*, 94: 691-719.

- Gutterman, A. (1997) 'Inter-Firm Cooperation, Competition Law, and Patent Licensing: A US-EC Comparison.' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Hadfield, G. (1990) 'Problematic Relations: Franchising and the Law of Incomplete Contracts.' *Stanford Law Review*, 42: 927-92.
- Hall, P. (1984) 'Patterns of Economic Policy: An Organizational Approach.' In Bornstein, D., Held, D. and Krieger, J. (eds.). *The State in Capitalist Society* (London: Unwin Hyman).
- Hall, P. (1986) *Governing the Economy* (Oxford: Oxford University Press).
- Hart, O. (1989) 'An Economist's Perspective on the Theory of the Firm.' *Columbia Law Review*, 89: 1757-84.
- Hart, O. (1990) 'Incomplete Contracts.' In Eatwell, J., Milgate, M. and Newman, P. (eds.) *Allocation, Information and Markets* (London: Macmillan).
- Hart, O. (1995) *Firms, Contracts and Financial Structure* (Oxford: Clarendon Press).
- Hart, O. and Moore, J. (1990) 'Property Rights and the Nature of the Firm.' *Journal of Political Economy*, 98: 1119-58.
- Hodgson, G. (1988) *Institutions and Economics* Cambridge: Polity.
- Hodgson, G. (1993) *Economics and Evolution: Bringing Life back into Economics* Cambridge: Polity.
- Hughes, D., Griffiths, L. and McHale, J. (1997) 'Do Quasi Markets Evolve? Institutional Analysis and the NHS.' *Cambridge Journal of Economics*, 21: 259-275.

- Hyman, R. and Ferner, A. (eds.) (1994) *New Frontiers in European Industrial Relations* (Oxford: Blackwell).
- Jensen, M. (1993) 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems.' *Journal of Finance*, 48: 831-880.
- Jensen, M. and Meckling, W. (1976) 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure.' *Journal of Financial Economics*, 3: 305-60.
- Joerges, C. (1991) *Franchising and the Law* (Baden Baden: Nomos).
- Klein, P. and Shelanski, H. (1995) 'Empirical Work in Transaction Cost Economics.' *Journal of Law, Economics and Organization*, 11: 335-361.
- Kotowitz, Y. (1990) 'Moral Hazard.' In Eatwell, J., Milgate, M. and Newman, P. (eds.) *Allocation, Information and Markets* (London: Macmillan).
- Kreps, D. (1990) 'Corporate Culture and Economic Theory'. In Alt, J. and Schepsle, K. (eds.) *Perspectives on Positive Political Economy* (Cambridge: Cambridge University Press).
- Kronman, A. (1977) 'Specific Performance.' *University of Chicago Law Review*, 45: 351-382.
- Kronman, A. (1978) 'Mistake, Disclosure, Information and the Law of Contracts.' *Journal of Legal Studies*, 7: 1-34.
- Kronman, A. (1985) 'Contract Law and the State of Nature.' *Journal of Law, Economics and Organization*, 1: 3-25.
- Kronman A., and Posner, R. (eds.) (1979) *The Economics of Contract Law* (Cambridge, Mass.: Harvard University Press).

- Lane, C. (1991) 'Industrial Reorganization in Europe: Patterns of Convergence and Divergence in Germany, France and Britain.' *Work, Employment and Society*, 5: 515-539.
- Lane, C. (1994) 'Industrial Order and Transformation of Industrial Relations: Britain, Germany and France Compared.' In Hyman, R. and Ferner, A. (eds.) *New Frontiers in European Industrial Relations* (Oxford: Blackwell).
- Levine, D. (1991) 'Just-cause Employment Policies in the Presence of Worker Adverse Selection.' *Journal of Labor Economics*, 9: 294-305.
- Levine, D. and Parkin, R. (1995) 'Work Organisation, Employment Security, and Macroeconomic Stability'. *Journal of Economic Behavior and Organization*, 24: 251-271.
- Luhmann, N. (1995) *Social Systems* (Stanford: Stanford University Press).
- Lyons, B. and Mehta, J. (1997a) 'Contracts, Opportunism and Trust: Self-interest and Social Orientation.' *Cambridge Journal of Economics*, 21: 239-257.
- Lyons, B. and Mehta, J. (1997b) 'Private Sector Business Contracts: The Text Between the Lines.' In Deakin, S., and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- McHale, J., Hughes, D. and Griffiths, L. (1997) 'Conceptualising Contractual Disputes in the National Health Service Internal Market'. In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).

- McKendrick, E. (1995) 'The Regulation of Long-Term Contracts in English Law', in Beatson, J. and Friedmann, D. (eds.) *Good Faith and Fault in Contract Law* (Oxford: Clarendon Press).
- Macaulay, S. (1963) 'Non-contractual Relations in Business: a Preliminary Study.' *American Sociological Review*, 45: 55-69.
- Macaulay, S. (1985) 'An Empirical View of Contract' *Wisconsin Law Review* 465-82.
- Macneil, I. (1974) 'The Many Futures of Contracts' *Southern California Law Review*, 47: 696-816.
- Macneil, I. (1978) 'Contracts: Adjustments of Long-Term Economic Relationships under Classical, Neoclassical and Relational Contract Law' *Northwestern University Law Review*, 72: 854-905.
- March, J. and Olsen, J. (1989) *Rediscovering Institutions: The Organizational Basis of Politics* (New York: Free Press).
- Marginson, P. (1993) 'Power and Efficiency in the Firm: Understanding the Employment Relationship.' In Pitelis C. (ed.) *Transaction Costs, Markets and Hierarchies* (Oxford: Blackwell).
- Marschak, T. (1990) 'Organisation Theory.' In Eatwell, J., Milgate, M. and Newman, P. (eds.) *Allocation, Information and Markets* (London: Macmillan).
- Masten, S. (1988) 'The Legal Nature of the Firm.' *Journal of Law, Economics and Organization*, 4: 181-98.
- Mattei, U. and Pardolesi, R. (1991) 'Economic Analysis in Civil Law Countries: A Comparative Approach.' *International Review of Law and Economics*, 11: 265-
- Medema, S. (1996) 'Coase, Costs, and Coordination.' *Journal of Economic Issues*, 30: 571-578.

- Ménard, C. (1995) 'Markets as Institutions Versus Organisations as Markets? Disentangling Some Fundamental Issues.' *Journal of Economic Behavior and Organization*, 28: 161-182.
- Milgrom, P. and Roberts, J. (1992) *Economics, Organization and Management* (Englewood Cliffs, NJ: Prentice-Hall).
- Montgomery, J. (1997) 'Control and Restraint in National Health Service Contracting.' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- North, D. (1990) *Institutions, Institutional Change, and Economic Performance* (Cambridge: CUP).
- North, D. (1993) 'Institutions and Credible Commitment.' *Journal of Institutional and Theoretical Economics*, 149: 11-23.
- North, D. (1994) 'Economic Performance through Time.' *American Economic Review*, 84: 359-68.
- Perrow, C. (1986) 'Economic Theories of Organisation.' *Theory and Society*, 15: 11-45.
- Pitelis, C. (ed.) (1993) *Transaction Costs, Markets and Hierarchies* (Oxford: Blackwell).
- Posner, R. (1993) *Economic Analysis of Law* (4th. ed.) (Boston: Little, Brown).
- Posner, R. and Rosenfield, A. (1977) 'Impossibility and Related Doctrines in Contract Law: An Economic Analysis.' *Journal of Legal Studies*, 7: 1-34.
- Powell, W. (1990) 'Neither Market nor Hierarchy: Network Forms of Organisation.' *Research in Organisational Behaviour*, 12: 295-336.

- Powell, W. and Di Maggio, P. (eds.) (1991) *The New Institutionalism in Organizational Analysis* (Chicago: University of Chicago Press).
- Pratt, J. and Zeckhauser, R. (eds.) (1985) *Principals and Agents. The Structure of Business* (Cambridge, Mass: Harvard Business School Press).
- Pratten, S. (1997) 'The Nature of Transaction Cost Economics.' *Journal of Economic Issues*, 31: forthcoming.
- Priest G. (1977) 'The Common Law Process and the Selection of Efficient Rules.' *Journal of Legal Studies*, 6: 65-82.
- Ramstad, Y. (1996) 'Is a Transaction a Transaction?' *Journal of Economic Issues*, 30: 413-425.
- Rosen, S. (1985) 'Implicit Contracts: A Survey.' *Journal of Economic Literature*, 23: 1144-75.
- Sako, M. (1992) *Prices, Quality and Trust. Inter-firm Relations in Britain and Japan*. Cambridge: Cambridge University Press.
- Sako, M. and Helper, S. (1996) 'Does Trust Improve Business Performance?' Paper prepared for the 8th. International Conference of the Society for the Advancement of Socio-Economics, University of Geneva, July 12-14.
- Saundry, R., Nolan, P. and Sawyer, M. (1998) 'Labour Regulation and Performance in Television and Port Transport: A Tale of Two Industries.' *Cambridge Journal of Economics*, 22: forthcoming.
- Scott, W.R. (1994) 'Institutions and Organizations: Towards a Theoretical Synthesis.' In Scott, W.R., Meyer, J. and associates *Institutional Environments and Organizations* (London: Sage).
- Scott, W.R. (1995) *Institutions and Organizations* (London: Sage).
- Schotter, A. (1981) *The Economic Theory of Social Institutions* (Cambridge: CUP).

- Schwartz, A. (1979) 'The Case for Specific Performance.' *Yale Law Journal*, 88: 271-306.
- Shleifer, A. and Summers, L. (1988) 'Breach of Trust in Hostile Takeovers.' In Auerbach, A. (ed.) *Hostile Takeovers: Causes and Consequences* (Chicago: University of Chicago Press).
- Simpson, A.W.B. (1996) 'Coase v. Pigou Reexamined.' *Journal of Legal Studies*, 25: 53-97.
- Stiglitz, J. (1986) 'On the Causes and Consequences of the Dependence of Quality on Price.' *Journal of Economic Literature*, 27: 1-48.
- Stiglitz, J. (1990) 'Principal and Agent.' In Eatwell, J., Milgate, M. and Newman, P. (eds) *Allocation, Information and Markets* (London: Macmillan).
- Summers, C. (1969) 'Collective Agreements and the Law of Contracts.' *Yale Law Journal*, 78: 537-75.
- Teubner, G. (1993) *Law as an Autopoietic System* Oxford: Blackwell.
- Thelen, K. (1991) *Union of Parts. Labour Politics in Post-war Germany* (Ithaca, NY: Cornell University Press).
- Vincent Jones, P. (1997) 'Hybrid Organisation, Contractual Governance, and Compulsory Competitive Tendering in the Provision of Local Authority Services.' In Deakin, S. and Michie, J. (eds.) *Contracts, Cooperation and Competition: Studies in Economics, Management and Law* (Oxford: Oxford University Press) (forthcoming).
- Whitley, R. (1992) 'Societies, Firms and Markets: The Social Structuring of Business Systems.' In Whitley, R. (ed.) *European Business Systems* (London: Sage).
- Williamson, O. (1975) *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press).

- Williamson, O. (1983) 'Credible Commitments: Using Hostages to Support Exchange.' *American Economic Review*, 73: 519-40.
- Williamson, O. (1985) *The Economic Institutions of Capitalism* (New York: Free Press).
- Williamson, O. (1986) *Economic Organization* (New York: New York University Press).
- Williamson, O. (1987) *Antitrust Economics* (Oxford: Blackwell).
- Williamson, O. (1993a) 'Calculativeness, Trust, and Economic Organization.' *Journal of Law and Economics*, 36: 453-86.
- Williamson, O. (1993b) 'The Evolving Science of Organization.' *Journal of Institutional and Theoretical Economics*, 149: 39-63.
- Williamson, O. (1995) 'Hierarchies, Markets and Power in the Economy: An Economic Perspective.' *Industrial and Corporate Change*, 4: 21-49.
- Williamson, O. (1996) *The Mechanisms of Governance* (Oxford: Oxford University Press).

