The Choice of Governing Mechanism: An Organization Economics Perspective

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Abstract

Organization economics, with its two main strands of transaction cost economics and agency theory, primarily deals with the question of how organizations emerge and survive. It focuses on the analysis of competition within hierarchies (organizations) rather than markets and addresses questions such as why organizations exist, how they are managed, why some perform better than others, and why they tend to cooperate. This study attempts to juxtapose other relevant perspectives and organization theories to bear on the same questions. The purpose is to understand where and how organization economics and other perspectives converge and diverge. The study depends on the work of famous scholars contributing to various perspectives for drawing conclusions.

Key Words: Transaction cost economics, agency theory, organization theory

Introduction

Modern organizations are complex and managers require a good deal of understanding to properly manage them. Not only are organizations complex but have to satisfy different stakeholders with (most often) conflicting goals. Both academicians and practitioners have come up with various theories and perspectives to facilitate better understanding of how organizations come into being, how structural and cultural characteristics affect their performance, and why some of them eventually decline and die.

Organization economics is concerned with the question of how organizations emerge and survive. It deals with the analysis of competition within hierarchies (organizations) rather than markets. For organizational economists, organizations exist in "seething caldrons" of competition where individuals, institutions, and governments all seek to obtain some part of the success that a particular firm may enjoy (Moran & Goshal, 1996). As a distinct perspective, it attempts to answer such questions as:

i. Why organizations exist?
ii. How firms should be managed?
iii. Why some organizations perform better than others?, and
iv. Why organizations tend to cooperate?

The economists Coase (1937) and Williamson (1975) explored the question by focusing on the transaction costs that are incurred in exchange relationships.

Transaction cost theory, a variant of organization economics, explores the question of why organizations exist. In his influential article, "the nature of the firm", Coase (1937) argued that negotiating, writing, and enforcing exchange contracts are costly. If there is uncertainty, firms must collect information on the value, price, quality, and availability of resources. A firm or organization may decide to reduce these costs by producing the resources itself or acquiring them from other firms. In other words, the reason for existence of firms is their ability to reduce cost of certain transactions. According to Williamson (1975), markets and hierarchies (governance mechanisms) are alternative instruments for completing a set of transactions. In general, mark forms of governance rely on prices, competition, and contracts to keep all parties to an exchange informed of their rights and responsibilities. Hierarchical forms of governance, on the other hand, bring parties to an exchange under direct control of a third party. These authoritative third parties then attempt to keep all parties to an exchange informed of their rights and responsibilities. Economic actors choose that form of governance (market or hierarchy) that reduces any potential exchange problems created by bounded rationality or the threat of opportunism.

The second stream of research within organizational economics, typified by agency theory, relates to answering the question of whether those associated with the firm agree about how it should be managed.

The agency theory, originally developed by Meckling (1976), focuses on the relationship between managers and stockholders. According to this theory, agency relationship occurs whenever one partner in a transaction (the principal) delegates authority to another (the agent) with the welfare of the principal affected by the choices of the agent. The delegation is problematic in that: (a) the interests of principal and agent will typically diverge; (b) the principal cannot perfectly and costlessly monitor the actions of the agent; and (c) the principal cannot perfectly acquire the information available to or possessed by the agent. These conditions constitute the possibility of opportunistic behavior on the part of agent against the welfare of the principal. Assuming that agency costs exist, it is clear that both the principal and the agent have strong incentives to minimize these costs. Thus, the principal and the agent have common interests in defining a monitoring and incentive structure that reduces outcomes as close as possible to what would be the case if information exchange were costless. The two sources of agency problems are the moral hazard and adverse selection on the part of agent.

The Strategic Management Theory developed by Porter (2008) addresses the question of why do some organizations outperform others. Porter has developed the five forces model of environmental threats and identified strategies to reduce such threats. The threats are: threat of rivalry, threat of substitute, threat of suppliers, threat of buyers and the thread of new entry. These threats either reduce the revenue of the firm or increase the cost the firm. Porter (2008) has identified different strategies to reduce these threats like exploiting economies of scale, differentiating products, and lobbying imposition of barriers to entry.

Cooperative Organizational Economics relates to collusion and strategic alliance of different firms in order to possess a monopolistic position or to enhance efficiency (Axelrod, 1984). A set of firms is said to be colluding when they cooperate to reduce the total output of products or services in an industry below what would be the case if they were competing in that industry (Bensaou, 1999). The collusion may either be explicit or tacit. Strategic alliance, on the other hand, is aimed to exploit resource complementarily. The resources controlled by two or more firms are complementary when their economics value combined is greater than their economic value separately (Gulati & Singh, 1998). There are two broad classes of strategic alliance: Contractual Alliance and Join Venture. The purpose of contractual alliance is to develop, design, manufacture, market or distribute products or services and where a separate firm is not created to manage this relationship. This relationship is managed through some sort of contract. Unlike tacit collusion, the effect of contractual alliance is to increase economic activities, not to reduce economic activities below the competitive level. Joint ventures are also cooperative relationship with the purpose of developing, designing, manufacturing, marketing products or services. Unlike contractual alliances, joint ventures always involve the creation of a separate firm to manage this relationship (Heide & John, 1990).

Insight from other Perspectives

The rational perspective, developed by classical economists (such as Adam Smith) and sociologists (such as Max Weber), is the most widely accepted and the one with the most compelling arguments concerning the origins of organizations. It attributes the emergence of organizations to the division and coordination of labour. Division of work implies that different people perform different activities because of the need to apply special skills to tasks for improving efficiency (Greif, 1995). And to the extent that the various skills required are of differential complexity, variable incentives structures evolved. Weber placed great emphasis on technical expertise and a fixed division of labour among officials (Weber, 1922). When work is divided, someone must oversee and coordinate the division so that each activity is rationally linked to the principal goal in addition to fixing responsibility for failure. In other words, horizontal division of labour is usually accompanied by a vertical hierarchy that provides oversight and thus organization comes into being (Smythe, et al., 2000).

The human relations perspective, developed and promoted by scholars such as McGregor (1960), Barnard (1938), and Eltan Mayoinsists that organizations are cooperative systems that have come into existence because of the limitations of individuals. The organizations rely on the willingness of participants to make contributions. A variety of incentives can be used to induce participants including material rewards, opportunities for distinction, prestige, and power (Mitchell & Lason, 1987). According to Chester Barnard, formal organizations arise out of and are necessary to informal organizations but when formal organizations come into operation, they create and require informal organizations. In formal structures facilitate communication, maintain cohesiveness, and promote willingness to serve the organization.

The contingency perspective, which is based on the work of Lawrence and Lorch (1967) and Woodworth (1965) who argue that appropriate managerial action and organization design depend on the particular parameters of the situation. As opposed to rational approach, which seeks universal principles to be applicable to every situation, contingency theory attempts to identify contingency factors (e.g. organizational size, strategy, competition, and technology etc.) that prescribe an appropriate design and action (Luthans, 1973). In other words, there is no one best organizational form or decision but many, and their suitability is determined by the goodness of fit between organizational form and environment or a particular decision and situation (Lawrance & Lorsch, 1967). Similar to the contingency perspective, transaction cost theory (a version of organizational economics) argues that markets and hierarchies are alternative instruments for completing a set of transactions. The economic actors will choose that form of governance (contingency) that reduces any potential exchange problems created by bounded rationality and the threat of opportunism.

According to Neo-Marxist perspective, organizations are social structures that protect and further the interest of the capitalist class (Braverman, 1974). Since the capitalist cannot personally supervise each task directly owing to physical, mental, or time constraints, he has to develop control mechanism in the form of organizational hierarchies and formal rules. The agency theory has an alternative explanation for the emergence of hierarchy and other control mechanisms. According to agency theory the delegation of authority from principal to agent is inevitable (cognitive and time constraints of the principal) but problematic in that the interests of principal and agent will typically diverge. Thus, the principal and agent have common interests in defining and monitoring and incentive structure that produces outcomes for less agency costs.

Another useful perspective for understanding organizations is the resource dependence approach. It means that organizations depend on the environment but strive to acquire control over resources to minimize their dependence (Pfeffer & Salancik, 1978). Organizations are vulnerable if vital resources are controlled by other organizations, so they try to be as much independent as possible. Organizations seek to reduce vulnerability with respect to resources by developing linkages with other organizations (Scott, 1981). Organization linkages require coordination which reduces the freedom of each organization to make decisions without concern for the needs and goals of other organizations. Dependence on shared resources gives power to other organizations. Organizational economics views the acquisition of resources from the environment as necessary for survival and organizations try to control resources by entering into strategic alliances with others. Porter (2008) developed a powerful model that firms use to choose and implement strategies that will generate above normal economic performance. Porter identified five set of threats to the profits of the firm in an industry: the threat of rivalry, the threat of entry, the threat of substitutes, the threat of suppliers and the threat of buyers.

All these threats act to either reduce a firm's revenues or increase its economic costs. The firm profits can motivate entry from at least two sources: from firms entering an industry from the outside, or from firms that are already in an industry entering into a

new segment of that industry. According to institutional perspective, just as organizations need efficient production to survive, they need legitimacy from the stakeholders as well (Meyer, & Rowan, 1977). It describes how organizations survive and succeed through congruence between an organization and the expectations from the environment. This view believes that organizations adopt structures and processes to please outsiders, and these activities come to take on rule-like status in organizations (Meyer, & Scott, 1983). Thus, according to the institutional perspective, organizations have two essential dimensions—technical and institutional. The technical dimension is the day to day work technology and operating requirements. The institutional structure is that part of the organization most visible to the outside public. The technical part is governed by norms of rationality and efficiency, but the institutional dimension is governed by expectations from the external environment (Meyer & Rowan, 1990). Organizations adapt to the environment by signaling their congruence with the demands and expectations stemming from cultural norms, standards set by professional bodies, funding agencies, and customers.

According to the network perspective, many organizations now occupy a middle ground between markets and hierarchies that are referred to as network organizations (Hamilton, 1986). Network organizations are temporary alliances, arrangements, or agreements designed to combine the core competencies and capacities of different firms for the purpose of research, design, and production for a particular market (Powell, et al., 1996). The network is characterized by cooperation, collaboration, and the sharing of information. The network reduces the problem of sunk costs in capital, inventory, and labour (Uzzi, 1997). Organization economics does not advocate any particular governance mechanism. According to transaction cost economics (a stream of organization economics), the choice of any governance mechanism (market, hierarchy, network) primarily depends on the cost of transaction which is affected by many factors including cost incurred on breach of contract and frequency of transaction.

Table 1: *Various perspectives on organization*

Questions	Organization Economics	Rational Perspective	Human Relations Perspective	Contingency perspective	Neo-Marxist Perspective	Resource Dependence Perspective	Institutional Perspective	Network Perspective
Why organizations exist?	To reduce costs and monitor performance	To achieve specific goals and enhance efficiency	To achieve complex (formal and informal) goals	To serve different stakeholders	To serve capitalist interests	To acquire valuable resources	To satisfy the needs of internal and external environment	To capitalize on the benefits of interdependence
How firms should be managed?	Through formal controls and norms	Through structural controls	Through cultural controls	No best approach—it depends	Through collaborative and cooperative mechanisms	Through internal cooperation and external competition	Through strategic fit	Through strategic alliances
Why some perform better than others?	Cost reduction	Best practices	Teamwork	Best fit	Shared benefits	Capitalizing on rare and valuable resources	Increased legitimacy through isomorphism	Flexibility
Why organizations tend to cooperate?	To achieve economy of scale		Organizations are embedded in society		To acquire more powers	To leverage on others strengths	To be considered part of the whole community	Norm of reciprocity prevails

Discussion and Conclusion

There has been a proliferation of literature on the choice of organizational forms from the perspective of Organization Economics (OE) where the underlying argument is based on efficiency. According to OE, some forms of governance (market, hierarchy, and network) are better in terms of transaction costs than others. Organization Economics, with its two main streams—transaction cost theory and agency theory—implicitly assumes that markets are efficient due to scale of economies, specialization, administrative costs and incentives (Boerner & Macher, 2001). But because contracts are incomplete due to future uncertainty and weak legal systems, markets may incur additional costs which leads to the firm becoming a cheaper alternative (Leiblein, 2003). However, hierarchical governance provides weaker incentives for performance because of team work (Leiblein, 2003). But there are then agency costs associated with hierarchy form of organization because of opportunism and asymmetry of information. Organization Economics, therefore, has been and will continue to be an important set of theoretical tools for the analysis of organizational phenomena. It addresses some of the most fundamental issues in organizational research and complements other theories of the firm to fully explain how organizations actually work. It, though, provides a useful lens through which various forms of organizations, is complete in all ways. A more useful approach toward building a science of organization would be to integrate legal, economic, sociological, and institutional perspectives. Focusing on any single perspective, however powerful it may be overshadows much of the empirical regularities thereby limiting its capacity to guide practice.

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