Visible and Invisible Governance
Author(s): Oliver E. Williamson
Source: *The American Economic Review*, Vol. 84, No. 2, Papers and Proceedings of the Hundred and Sixth Annual Meeting of the American Economic Association (May, 1994), pp. 323-326
Published by: American Economic Association
Stable URL: http://www.jstor.org/stable/2117852
Accessed: 09/04/2013 08:18

Visible and Invisible Governance

By Oliver E. Williamson*

Although the invisible hand of competition—according to which "Every individual...intends only his own gain, and he is in this, as in so many other cases, led by an invisible hand to promote an end which was no part of his intention"—is credited to Adam Smith (1776 [1976 p. 477]), both Carl Menger (1883) and Emma Rothschild (1994) express precautions. It was Menger's judgment that Smith and his followers had a "defective understanding of the unintentionally created social institutions and their significance for economy.... [They view] the institutions of economy...[as] the intended product of the *common will* of society as such, results of expressed agreement of society or of positive legislation.... The broad realm of unintentionally created social structures remains closed to their theoretical comprehension" (Menger, 1985 p. 172 [emphasis added]).

Indeed, it was Menger who advanced the much more ambitious view that "Law, language, the state, money, markets, ... [the] prices of goods, interest rates, ground rents, wages, and a thousand other phenomena" are to "no small extent the unintended result of social development" (1985 p. 147), whereupon the fundamental challenge for the social sciences was posed as follows: "How can it be that institutions which serve the common welfare and are extremely significant for its development come into being without a common will directed toward establishing them?" (1985 p. 146). Friedrich Hayek (1945 p. 527) and Karl Popper (1965 p. 342) subsequently expressed similar views. The proposition that "Invisible-hand explanations of phenomena...yield greater understanding than do explanation of them as brought on by design as the object of people's intentions" (Robert Nozick, 1974 p. 19) has made progressive headway and now enjoys widespread support.

My views are that a choice does not need to be made and that still greater understanding will be realized by appealing to *both* invisible- and visible-hand explanations, provided that this is done in a disciplined way. The caveat reflects Gresham-law concerns: easy arguments (bad money) will drive deeper arguments (good money) out of existence where naive intentionality corresponds to an easy argument[1] and spontaneous order is a deeper argument.

Intentionality analysis does not need to be naive, however, and intentional and spontaneous order often work together. I develop the argument by taking the central problem of economic organization to be that of "rapid adaptation to changes in the particular circumstances of time and place" (Hayek, 1945 p. 524).

I. A Puzzle

Dennis Robertson once described firms as "islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk" (1923 p. 85). The unconscious cooperation to which he referred was, of course, the invisible hand of the market. Conscious cooperation within the firm nevertheless posed a puzzle: Why "in view of the fact that it is usually argued that co-ordination will be done by the price mechanism,...is such [conscious] organization necessary?" (Ronald H. Coase, 1937 p. 387).

*Department of Economics and Haas School of Business, University of California, Berkeley, CA 94720.

[1]Naive functionalism supplies *ex post* rationalizations for outcomes in which some intent is purportedly served. That is an easy exercise, but it is irrefutable and undisciplined. Intentional explanations need not be of a naive functionalist kind.

A related puzzle was posed, albeit at a higher level of aggregation, by the Socialist controversy. The merits of the market, in relation to central planning, was the issue that pitted Oskar Lange and Abba Lerner on the side of planning against Ludwig von Mises and Hayek on behalf of the market. Although the early verdict was that Lange and Lerner had won this exchange (Joseph Schumpeter, 1942 p. 172; Abram Bergson, 1948 pp. 440–47), Hayek was unpersuaded and persisted with his argument that the central plan could not be implemented.

Hayek's main argument was that those who subscribed to central planning had slighted the importance of local, idiosyncratic information (Hayek, 1945 p. 522). Because much of the relevant information pertinent to a high-performance economy was local and could not be communicated quickly and cheaply (if at all) to the center (thereupon to be aggregated or otherwise combined with other relevant information and appropriate individual and combined responses prescribed), Hayek concluded that decentralized decision-making, in which prices signaled opportunities and adaptation was accomplished in the market, was the superior way to organize.

The puzzle referred to earlier, however, persisted: "Pushed to its logical extreme," exclusive reliance on local or specific knowledge would imply "more or less complete atomization of the economy" (Michael Jensen and William Meckling, 1992 p. 260). Wherein does conscious coordination arise?

II. Cooperative Adaptation

The need for and neglect of conscious cooperation were evident to a contemporary of Hayek's, Chester Barnard, who complained that social scientists in general and economists in particular had failed to appreciate or even to "sense the processes of coordination and decision that underlie a large part of the phenomena they described. More important, there was lacking much recognition of formal organization as a most important characteristic of social life" (Barnard, 1938 p. ix), where by formal organization Barnard meant "that kind of cooperation among men that is conscious, deliberate, purposeful" (1938 p. 4). If real time responsiveness between interdependent stages was the pressing need, then coordination through administration, rather than the market, had a good deal to recommend it.

Note in this connection that Barnard, like Hayek, held that the central problem of economic organization was that of adaptation. Confronted with a continuously fluctuating environment, the "survival of an organization depends upon the ... readjustment of processes *internal to the organization* ... by which [adaptation] is accomplished" (Barnard, 1938 p. 6 [emphasis added]). The need, evidently, is to recognize that a high-performance economy will combine the capacity for autonomous adaptation (in the market) with cooperative adaptation (in the firm) in a discriminating way. Visible and invisible hands are thus joined.[2]

III. Background Supports

What, however, are the instruments that permit firms to implement cooperative adaptations that markets cannot? Also, and relatedly, what are the institutional supports?

As developed elsewhere (Williamson, 1991), I argue that the main instrument to which firms have access that markets do not is fiat. That, however, merely relocates the problem: wherein does fiat arise?

The exercise of fiat through hierarchy is, of course, a very conscious, deliberate, and purposeful way of accomplishing coordination. As it turns out, such fiat is supported by two very spontaneous (almost invisible) forces: forbearance law and informal organization.

[2]In a separate but related way, Joseph Stiglitz (1993 p. 111) describes the Walrasian model as one that "focused only on those situations where what coordination was required could be attained through the price system."

A. *Forbearance Law*

Whereas the contract law of markets is (comparatively) legalistic and prescribes that courts are the forum of ultimate appeal, the (implicit) contract law of hierarchy is that of forbearance, according to which internal organization becomes its own court of ultimate appeal (Williamson, 1991). Thus, whereas courts routinely grant standing to firms should there be disputes over prices, the damages to be ascribed to delays, failures of quality, and the like, courts *will refuse* to hear disputes between one internal division and another over identical technical issues. Access to the courts being denied, the parties must resolve their differences internally. As a consequence, hierarchy becomes its own court of ultimate appeal.

The underlying rationale for forbearance law is twofold: (i) parties to an internal dispute have deep knowledge—both about the circumstances surrounding a dispute and about the efficiency properties of alternative solutions—that can be communicated to the court only at great cost, and (ii) permitting internal disputes to be appealed to the court would undermine the efficacy and integrity of hierarchy. If fiat were merely advisory, in that internal disputes over net receipts could be pursued in the courts, the firm would be little more than an "inside contracting" system (Williamson, 1985 pp. 218–22). The application of forbearance doctrine to internal organization means that parties to an internal exchange can work out their differences themselves or appeal unresolved disputes to the hierarchy for a decision. But this exhausts their alternatives. When push comes to shove, "legalistic" arguments fail. Greater reliance on instrumental reasoning and mutual accommodation result. The argument that the firm "has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting" (Armen Alchian and H. Demsetz, 1972 p. 777) is exactly wrong: firms can and do exercise fiat that markets cannot.

The question then becomes this: wherein does forbearance law arise? In particular, does forbearance law have intentional origins or did it arise spontaneously? I conjecture that forbearance law is the evolutionary product of business and the law groping for a contractual logic that "worked," which is to say that forbearance law was not consciously invented but mainly evolved. Moreover, because of its spontaneous origins, it is almost subliminal and goes unremarked: courts practice forbearance law without (usually) expressly articulating it.

B. *Informal Organization*

His emphasis on formal organization of an intentional kind notwithstanding, Barnard made express provisions for informal organization, which unlike formal organization, arose spontaneously. Not only do formal and informal organization always and everywhere coexist (Barnard, 1938 p. 20), but informal organization contributes to the viability of formal organization (Barnard, 1938 pp. 122, 169). Barnard's insistence on intentionality did not, therefore, obliterate spontaneous order. Rather, the latter is inseparable from and in significant respects *supports* the former.

Barnard observes with respect to this last that (1938 p. 169):

> Since the efficiency of organization is affected by the degree to which individuals assent to orders, denying the authority of an organization communication is a threat to the interests of all individuals who derive a net advantage from their connection with the organization, unless the orders are unacceptable to them also. Accordingly, at any given time there is among most of the contributors an active personal interest in the maintenance of the authority of all orders which to them are within the zone of indifference. The maintenance of this interest is largely a function of informal organization.

IV. Concluding Remarks

The problem of economic organization is usefully posed as one of comparative analysis of discrete structural alternatives in which both spontaneous (invisible) and intentional (visible) features are combined in varying degrees. Viewed instrumentally, all forms of organization are accorded respect; and because each has a role to play, none is accorded undue respect.

The upshot is that the marvel of the (invisible) market is examined in relation to the marvel of the (visible) hierarchy. Although that complicates the study of economic organization, it also invites analysis of a more probing and less contrived kind. The range of phenomena to which an economic approach can be brought fruitfully to bear is expanded in the process. The combined study of law, economics, and organization is implicated.

REFERENCES

Alchian, Armen and Demsetz, H. "Production, Information Costs, and Economic Organization." *American Economic Review*, December 1972, *62*(5), pp. 777–95.

Barnard, Chester. *The functions of the executive*. Cambridge, MA: Harvard University Press, 1938.

Bergson, Abram. "Socialist Economics," in Howard Ellis, ed., *Survey of contemporary economics*. Philadelphia, PA: Blakiston, 1948, pp. 430–58.

Coase, Ronald H. "The Nature of the Firm." *Economica, New Series,* November 1937, *4*(16), pp. 386–405.

Hayek, Friedrich. "The Use of Knowledge in Society." *American Economic Review*, September 1945, *35*(4), pp. 519–30.

Jensen, Michael and Meckling, William. "Specific and General Knowledge, and Organizational Structure," in Lars Werin and Hans Wijkander, eds., *Contract economics*. Oxford: Blackwell, 1992, pp. 251–74.

Menger, Carl. *Untersuchungen über die Methode der Soczial wissenschaften und der Politischen Oekonomie insbesondere*. Leipzig: Duncker & Humboldt, 1883; English translation, *Investigations into the method of the social sciences with special reference to economics*. New York: New York University Press, 1985.

Nozick, Robert. *Anarchy, state, and utopia*. New York: Basic Books, 1974.

Popper, Karl. *Conjectures and refutations*. New York: Harper, 1965.

Robertson, Dennis. *Control of industry*. London: Nisbet, 1923.

Rothschild, Emma. "Adam Smith and the Invisible Hand." *American Economic Review*, May 1994 (*Papers and Proceedings*), *84*(2), pp. 319–22.

Schumpeter, Joseph. *Capitalism, socialism, and democracy*. New York: Harper & Row, 1942.

Smith, Adam. *The wealth of nations*. London: W. Strahan and T. Cadell, 1776; reprinted, Chicago: University of Chicago Press 1976.

Stiglitz, Joseph. "Post Walrasian and Post Marxian Economics." *Journal of Economic Perspectives*, Winter 1993, *7*(1), pp. 109–14.

Williamson, Oliver E. *The economic institutions of capitalism*. New York: Free Press, 1985.

______. "Comparative Economic Organization: The Analysis of Discrete Structural Alternatives." *Administrative Science Quarterly*, June 1991, *36*(2), pp. 269–96.