Ah, yes: Governance!

The quality of an economy's contract laws and enforcement efforts can be inferred indirectly from the evidence on contracting.

Why are the ambitions of economic development and reform so often disappointed? One answer is that developers and reformers are congenital optimists. Another answer is that good plans are regularly defeated by those who occupy strategic positions in the implementation process. A midway answer is that institutions are important and are persistently neglected in the planning of development and reform.

But if institutions are so obviously important, how and why are they important? And what should policymakers do to foster effective institutions? That has been a daunting challenge to which the new institutional economics is only now beginning to respond. Note in this connection that the predilections of both (optimistic) planners and (cynical) implementers are features to which institutional economists should be expected to respond—by creating institutions that take these predilections into account.

Oliver Williamson adopts a partial, positive approach that examines institutions of governance (firms, markets, mechanisms) to find out “What’s going on out there?” He examines the governance of contract, investment, and private ordering through the lens of economizing on transaction costs (see box).

**The microanalytics**

Transaction-cost economics makes the transaction the basic unit of analysis. That is a critical move—in that it shifts attention away from the orthodox focus on price and output to consider the attributes of transactions. But the move is completed only upon identifying the critical dimensions in which transactions differ.

Transaction-cost economics avers that the key dimensions are the frequency with which transactions recur, the uncertainties to which they are subject, the degree of asset specificity, and the ease of measurement. As it turns out, asset specificity—the degree to which transactions are supported by durable, nonredeployable assets—is especially important to the governance of contractual relations.

**Credible commitments**

Although the classic transaction in law and economics—the trading of a homogeneous good in a market with large numbers of buyers and sellers—is well serviced by spot markets in which the identity of the parties is unimportant, things become more complicated as buyers and suppliers become dependent on one another.

Buyers who ask suppliers to make durable, specialized investments in support of their requirements are, in effect, creating a condition of bilateral dependency. Suppliers cannot redeploy those assets without loss of productive value. Buyers cannot turn to others to get ready relief in the event of contractual breakdown.

Because spot contracting is poorly suited to meeting the needs of the parties in these circumstances, long-term contracts—with added security features, added information disclosure provisions, and special dispute settlement mechanisms—arise in support of these more complex transactions. Identity matters.

Indeed, because the benefits of uncontested adaptations are perceived to be especially great, transactions may be taken out of the market and organized internally.

If confidence in the governance supports for long-term contracting transactions is lacking, what could otherwise be viable middle-range transactions will flee to one of the poles—by moving to the spot market (attended by the sacrifice of asset specificity and resulting loss of pro-

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Widespread reliance on subcontracting will thus be observed in a high-performance economy. The quality of an economy’s contract laws and enforcement efforts (including its permissiveness, or not, toward private ordering) can thus be inferred indirectly from the evidence on hybrid contracting (rather than directly, by examining the laws and the qualifications of the judiciary).

The mechanisms

Good laws and constitutions are always to be preferred to defective laws and constitutions, but laws and constitutions—both good and bad—are not self-enforcing. That is both good news and bad. The good news is that apparent defects in laws and constitutions can often be patched up or rectified by the mechanisms of governance. The bad news is that what appear to be good laws and constitutions may be ineffectual.

One of the lessons of transaction-cost economics is to be permissive toward private ordering. Because there are always (potential) mutual gains to be realized by moving from a less to a more efficient relation, the possibility that nonstandard and unfamiliar contracting practices serve efficiency purposes should be actively entertained.

Being respectful of private ordering has ramifications both for the economic theory of contracting and for antitrust. The theoretical message is this: it is impossible to concentrate all of the relevant contracting action in the ex ante incentive agreement (through the clever use of pecuniary penalties, for example). And antitrust is advice that the inhospitality tradition—according to which nonstandard forms of contracting and organization were presumed to have anticompetitive purpose and effect—by recognizing that complex contracts, which of necessity are incomplete, cannot function effectively without governance supports for private ordering. For example, the long-standing view that exchange agreements—under which petroleum firms exchanged product (in surplus and deficit regions) rather than operate through the market—were anticompetitive turned out to be mistaken. In the absence of preexisting market power, exchange agreements should be regarded as mechanisms for giving and receiving credible commitments.

Similar considerations apply to property. Consider the matter of “taking,” where a taking may be defined as “constitutional law’s expression for any sort of publicly inflicted private injury for which the constitution requires payment of compensation.” The question is how this provision, which is not self-enforcing, is to be implemented.

Investors who realize that they are disadvantaged in relation to other, more favored members of society can and will adapt in a variety of ways. Thus more durable assets will be supplanted by less durable ones. Nonmobile assets will be supplanted by more mobile ones. Conspicuous assets will give way to those that can be sequestered. And assets may flee by relocating in more secure jurisdictions.

More generally, nonredeployable investments that would be made in a secure investment regime will be supplanted by more redeployable assets and by capital flight and asset concealment. Productivity will be lost as a result.

The basic point is this: rather than focusing mainly or exclusively on the constitution (top down), the quality of a compensation regime is to be inferred mainly from an examination of the mechanisms. A credible investment approach in which farsighted but incomplete contracting is featured is an instructive way to unpack the issues of secure expectations.